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THE GROWTH OF PROTECTION IN CANADA: ITS CONSEQUENCES AND SOME SUGGESTIONS FOR TARIFF REFORM

by

© Donald Peder McLennan

A THESIS

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The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies for acceptance, a thesis entitled THE GROWTH OF PROTECTION IN CANADA: ITS CONSEQUENCES AND SOME SUGGESTIONS FOR TARIFF REFORM submitted by Donald Peder McLennan in partial fulfilment of the requirements for the degree of Master of Business Administration.

ABSTRACT

Commercial policy is an issue of great concern to all Canadians. This study traces the history of protectionism in Canada and discusses the classic debate surrounding the case for free trade both from the historical point of view and as it applies to Canada. Several hypotheses are tested with regard to the economic effects of tariff protection and economic implications of the lowering of trade barriers in the general direction of multilateral free trade.

It is found that the tariff, by protecting Canadian industry, allows inefficient high-cost production thereby raising prices to the Canadian consumer and lowering his real standard of living. The relevance of the arguments for tariff protection to the technologically advanced Canadian economy are determined to be slight. For reasons of efficiency, it is suggested that Canada's economic interests lie in the multilateral lowering of trade barriers. The substantial economic benefits to be gained from regional economic integration on a North American scale indicate that such a move would provide an important interim step in this direction.

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CHAPTER I

TO CHART A COURSE

In recent years Canadian imports of goods and services have averaged around 16% of gross domestic product (G.D.P.), and exports of goods and services around 17% of G.D.P. Because these figures are four to five times the corresponding figures for the United States, Canadians often place great stress upon the relative openness of their economy. Commercial policy - that is, policy directed toward influencing the extent and nature of a country's foreign trade - is certain to be of considerable importance in an economy with a substantial dependence on international trade. It is not surprising, therefore, that Canadians have been vitally interested in the commercial policies followed by their own government and those of the countries with which Canada trades.

When this study was being planned, it was evident that the breadth of the topic under consideration would call for extensive research into various related subjects but would allow little specialization among them. The topic in question concerns primarily the growth of protection in Canada, the effect of Canadian commercial policy on the economy, and some suggestions for reform. It is hoped however that the very broad nature of the assignment, resulting in generalizations and a somwhat cursory treatment of certain issues, will not fully impair the logic and course of the arguments raised in

dealing with the subject.

The methodology used in this thesis is comprised of literature research with a view to objectively evaluating certain hypotheses regarding the Canadian tariff and its effect on the exchange of goods and services both into and out of this country with particular attention being paid to the United States, Canada's largest customer and largest supplier. Not the least of the author's objectives was the simple idea of self-education in the area under study and this aim was instrumental in structuring and choosing the issues to be emphasized in the body of the study.

By tracing the history of some of the practical and theoretical arguments behind the advancement of the cases for both free trade and tariff protection, and by relating the historical perspective thus gained to the Canadian scene, an effort will be made to evaluate the following hypothesis: the national policy in Canada, rather than permitting Canadians to remain independent from the United States while encouraging rapid economic growth and diversification, has instead had almost the opposite effect resulting in both the development of a branch plant economy in Canada with a dependence on American capital and a sizeable reduction in the Canadian standard of living. Throughout, a general theme will be developed, mainly the trend towards the regionalization of world trade, and an attempt will be made to relate Canada's external economic relations and trade problems to that theme. This

argument will take the form of a further hypothesis that much would be gained in Canada from a policy of multilateral tariff reduction beginning with closer economic integration and the lowering of trade barriers between Canada and the United States. The gain in Canada, it is contended, would result mainly from the rationalization of Canadian industry accompanied by an increase in real incomes in Canada.

Chapter two relates the historical perspective of free trade and traces its development from the days of mercantilism through economic nationalism and up to the present including the evolution of the General Agreement on Trade and Tariffs (GATT) and the trend towards regionalization of world trade. Some of the classic arguments used in the debate on free trade vs. protection are introduced and an attempt is made to relate the case for freer trade to the Canadian position today.

In Chapter three, attention is focused on the Canadian tariff, its history, its structure, and some of its underlying theory. The role of the tariff as part of the national policy in the building of the Canadian nation is discussed and the long-standing issue of reciprocity with the United States is introduced. It is pointed out that political considerations related to broad national objectives in addition to economic considerations have often played a major role in Canadian tariff history.

Chapter four deals with the case for tariff reform in Canada, a case which rests on the evaluation of the effects of

a policy of protection, a policy which involves a cost both in cash and economic terms. The concept of a 'scientific tariff' is introduced and as part of the discussion on the reforming of Canadian tariff structure a distinction is made between multilateral, bilateral, and unilateral reductions.

In Chapter five, the logical progression of issues is carried a step further, and the implications of a scheme for Canadian-American economic integration are analyzed in some detail. The hypothesis that Canada has much to gain from such a scheme is thoroughly tested in this section.

The range and extent of American influence on the Canadian economy is a subject guaranteed to stimulate heated debate in Canada. Each year brings forth an impressive volume of technical research and editorial opinion concerning the 'vulnerability' of the Canadian economy, and its growing 'dependence' on the U.S. This issue remains a many-sided one, and while this study can in no way be interpreted as a definitive statement on the subject, it is hoped that the questions raised and the conclusions drawn will help illuminate some areas of the debate.

CHAPTER II

HISTORICAL PERSPECTIVE OF FREE TRADE

2.1 Introduction

In studying the commercial policies in effect today, something must be understood of their past. During the nineteenth century, large changes in ideas and policies took place concerning international trade and the first effort was made to establish a world economic community. The beliefs on which this effort was based revolved around the classical case for free trade and the nineteenth century free traders in their idealism envisaged a world of freedom, wealth, and universal peace. However, in the twentieth century, economic nationalism and policies of protectionism continue to abound.

Nevertheless, the past 25 years have seen substantial changes and developments in the world of international trade. The question of economic relations has become partly a question of participating in international intercourse as opposed to political isolationism. The growth of international trade arrangements such as the General Agreement on Trade and Tariffs, the International Monetary Fund, and the European Economic Community imply that Canadian economic development cannot be fully isolated from world economic development.

2.2 A Survey of History

2.2.1 Mercantilism

The first large-scale free trade movement took place in the nineteenth century and replaced the economic policy of mercantilism. Mercantilism lay at the heart of the economic philosophies and policies of European nations for 300 years before the doctrine of free trade. "The philosophy of mercantilism was economic nationalism".[1] The purpose of economic policy was nation-building, and economics was of secondary importance to politics, diplomacy and warfare.

The chief instruments of economic policy, in this great era of overseas empire, were the royal granting of private monopolies, the extensive regulation of domestic industry, and heavy restrictions on foreign trade. There existed one uniform policy in foreign trade, a policy of restriction, exclusiveness, and discrimination designed to strengthen domestic industry and commerce and to hamper those of other nations.

The North American colonies were regarded simply as extensions of Britain's economic and diplomatic policy of mercantilism. The preferential duties given the colonies in the British markets were recognized by Canadian merchants in the timber and wheat trades (i.e., staples) to be the basic foundations of their prosperity. The British North America Act after the American Revolution became extremely mercantilist and the exclusive imperialism practised by Britain raised

up great protected vested interests in Canada. These then became the "vested interests of colonial mercantilism" leading the vanguard of protectionism despite the fact that from the very beginning of exploration and settlement in this country export markets had been the vital link between economic wealth and progress.

2.2.2 Campaign for Free Trade

In 1846, the British parliament, after a long struggle, repealed the high tariff against wheat and other grains. With this, Britain embarked on a policy of free trade that eliminated the preferred position enjoyed by the colonies in the British market. The repeal of the Corn Laws, together with the granting of responsible government, destroyed the basic foundations of the Tory merchant class of Canada.

The depression of 1847-48 led to the 1849 appearance of the Annexation Manifesto signed by some of the leading businessmen of Montreal, which proposed the immediate annexation of Canada to the U.S. The loyalty of the Canadian merchant to the British Connection had proved to be no deeper than the tariff. Various business and economic interests in the community in both Britain and Canada, had come to look upon the government as an agency that should protect their private interests whenever they were threatened by foreign trade.

The Corn Law controversy saw the birth of systematic

economic theory, the theory of the classical political economists. This included the theory of comparative advantage in international trade, one of the mainstays in the promotion of free trade.

The era of free trade inaugurated by the repeal of the Corn Laws proved to be rather short-lived. By the late 1870's, free traders, previously the leaders of a progressively victorious movement, became the defenders against mounting protectionist sentiment. A German tariff in 1879, moderate but protectionist in intent, was soon imitated by other countries, thus bringing to an end reciprocal trade treaties all over Europe.

2.2.3 Protectionism

Many forces brought about the revival of protection during the period 1879 to World War II. Prior to 1914, the main force behind the protectionist movement rested on an identification of economic wealth and progress with industrialization. This view became widespread during the late 19th and early 20th centuries and was supported by the historical development of England, Germany, and the United States. Unfortunately the fact that Britain had been a free trader during much of this period of prosperity was not accorded the same emphasis as the doctrine of protection.

An influential theoretician, the German economist Friedrich List, argued that a nation that progresses must advance

through distinct economic stages, of which the stage of industrialization is the most advanced and the wealthiest.[2] He went on to say that this process could be accelerated by a policy of encouragement to national industry, of which the simplest and most direct was tariff protection against the products of the industry of other nations.

The view that industrialization could be successfully promoted by tariff protection was also supported by the most influential English classical economist of the period John Stuart Mill. While an economic internationalist, Mill admitted in his well-known book the "Principles of Political Economy" that the protectionist "infant industry argument" might be theoretically sound.[3] This argument promoted the idea of temporary protection. The tariff could be used to assist a new industry in getting started while envisaging the growth of such industries to maturity where they would be able to withstand competition thus allowing the tariff to be removed. The argument is an old one dating from the mid 17th century, and it became a strong weapon in protectionist hands.

These appeals to the tariff as an instrument for the promotion of industrialization and national economic progress were the most important elements of the protectionist movement of the pre-World Wart I period. The infant industry and national development arguments, were rather weak as purely economic arguments, but through the late 19th century, there was developing a basis for protectionist policy that was far

more powerful. This was the argument for national economic self-sufficiency as a part of a nation's military or defence policy. The revival of protectionism was inseparable from the great growth of nationalism as a political force at this time.

It is interesting to note that the ardent free traders of the 1840's also considered the questions of war and national security or self-sufficiency. They arrived at the conclusion however that free trade was highly desirable on these grounds. Their argument was that trade would forge economic and cultural connections among the nations of the world, that this would make all nations more cosmopolitan, and thus eliminate war through common economic interests. Mill echoed this viewpoint as follows:

> "It is commerce which is rapidly rendering war obsolete, by strengthening and multiplying the personal interests which are in natural opposition to it. And it may be said without exaggeration that the great extent and rapid increase of international trade, in being the principle guarantee of the peace of the world, is the greatest permanent security for the uninterrupted progress of the ideas, the institutions, and the character of the human race."[4]

However, when nations returned to the policy of protection, it meant the end of the first international economic community. It was a simple fact that the world had entered a new era and protectionism became again, as it had been in the 18th century, an instrument of national military policy.

2.2.4 Reconstruction

The first World War shattered the first international economy but the Great Depression broke it completely. The constriction and disruption of world trade was accomplished by a variety of interferences with trade imposed by countries desperately seeking to prevent the loss of foreign exchange reserves and to increase domestic employment.

Plans were made at the end of World War II for reconstruction of the international economy in which international trade and payments could be freely conducted on a multilateral basis, and international competition would not be distorted by the bilateral arrangements and quota and exchange control interferences which had become common in the 1930's. Such a system required: (1) on the monetary side, provision of additional international reserves, the acceptance of control over international capital movements, and a means of changing with international agreement, the exchange rate of any country in fundamental disequilibrium, all provided through the establishment of the International Monetary Fund; (2) on the side of trade policy, a "code of fair practice" in international trade provided through the General Agreement on Trade and Tariffs (GATT); and (3) provision for a substantial flow of international lending provided through the International Bank for Reconstruction and Development (I.B.R.D.).

2.2.5 GATT

The aspect of the above plans for the reconstruction of the international economy which is relevant here is those rules governing trade embodied in GATT. These rules for international trade policy are built on the central principle of non-discrimination meaning suppliers in foreign countries should have access to a country's market on equal terms. That is, a country should not give preferential advantage in its market to suppliers in particular foreign countries. Members are bound not to increase pre-existing preference margins or to introduce new preferences in their tariff schedules, and are also bound to extend tariff concessions negotiated with one another to all other members on the most-favoured-nation (m.f.n.) principle.

The major exception to this ban on new preferences allows members to form customs unions or free trade areas provided the average tariff on trade with outsiders is not increased. (Both a customs union and a free trade area entail the elimination of tariffs between participants; a customs union also entails the adoption of a common tariff schedule for trade with non-participants, whereas participants in a free trade area retain their individual tariff schedules on outside trade).[6] The logic of this exception is that presumably preferences are likely to be granted at the expense of foreign competitors and therefore are not likely to represent a genuine movement towards freer trade whereas an across-the-board elimination of

barriers is more likely to mean a genuine movement towards freer trade. The use of GATT meetings through the 1950's and 1960's accomplished substantial reductions in tariffs largely as a result of American and Canadian willingness to offer concessions. The latest rounds have accomplished much less primarily because of the growth of protectionist sentiment in the United States.

2.2.6 Regionalization

More recently, the dominant motif in the evolution of international trade has been the trend towards regional trading arrangements. Any discussion of free trade must necessarily include reference to the emergence of these regional groupings, and to the philosophy which lies behind them. This philosophy differs markedly from both the 19th century free trade doctrine and contemporary North American ideas on trade liberalization.

Regional trading arrangements in Europe are the expression of a fundamental change affecting world trade, the recovery and rapid industrial development of Europe. Other important changes in the offing include: most immediately, the emergence of Russia in world trade as a consequence of her rapid growth; and in the longer run, the effects of the industrialization of the underdeveloped countries. Together these changes indicate a shift in the pattern and centre of gravity of international trade and in particular, a relative

decline in the economic power of the United States.[7]

After the Second World War, the economic recovery of Europe was slowed by the disruption of East-West European trade from communist assumption of power in Eastern Europe, by the ensuing Cold War, and by a shortage of dollars. But in 1947, the Marshall Plan from the United States, matched by the Organization for European Economic Cooperation (OEEC), laid the foundation for the regionalization of trade.

The anticipated achievement of high rates of economic growth based on the exploitation of modern technology, the accumulation of industrial capital, and the absorption of labour into higher productivity industrial employment made it politically possible for France, Italy, Germany, and the Benelux countries to contemplate forming a common market. The scheme for a Common Market, first proposed in 1955 was the natural outgrowth of the success of an earlier effort at economic integration of these six countries, the European Coal and Steel Community (ECSC). The ECSC originated in 1950 as the Schuman Plan, a French proposal for the formation of a common market in coal and steel.

The proposal for forming a customs union among the six members of the ECSC was culminated by the signing of the Treaty of Rome, formally establishing the European Economic Community (EEC) in March, 1957. The treaty provided for the free movement of capital and labour, the coordination of economic and social policies, special arrangements for agri-

culture, the harmonization of various conditions of competition, and the setting up of new supra-national institutions, in short, thorough economic integration, symbolized by the term "common market".

Earlier in the negotiations in mid 1956, it had been suggested that other members of the OEEC might be associated with the economic union of the six through the formation of a free trade area. Negotiations failed however leaving the other European countries most heavily engaged in exporting to the six with the following alternatives: (1) work out bilateral arrangements with the six; or (2) form a free trade area among themselves in the expectation that it would eventually be associated with the Common Market. The latter course was chosen, and in 1959, the "Outer Seven" countries of Europe, the Scandinavian countries, Britain, Switzerland, Austria and Portugal, negotiated and signed a convention establishing the European Free Trade Association (EFTA). Thus Europe was divided into two groups, each pursuing the elimination of internal trade barriers though by different approaches.

2.2.7 Underlying Philosophy

The procedure for establishing internal free trade in both the European schemes was broadly the same and very different from the procedure under GATT. It has four main characteristics: (1) tariffs are reduced by stages fixed in advance and reductions are automatic; (2) all tariffs are reduced by

roughly the same percentage at a given stage; (3) dislocations and hardships to particular industries are dealt with by special assistance rather than by exemption from tariff reduction; and (4) any exception to this principle must be designed to be of limited duration.

Under GATT however, tariffs are reduced by negotiations conducted at regular intervals at the discretion of members, bargaining concerns individual tariff rates and not tariff levels, and the results are irrevocable in the case of hardship. Whereas the regional grouping concentrates on the general objective of tariff reduction, under GATT members concentrate on specific concessions emphasizing the adverse effects of tariff reduction on certain domestic industries.

Why is reciprocal free trade thought to be beneficial? The chief motivation is obtaining larger freely competitive markets for the output of expanding industry, (The Common Market also includes free movement of labour and capital or "equal access to factors of production", harmonization of social and fiscal policies affecting international competition, and control of private restrictions on competition.) thereby encouraging the exploitation of technical progress and economies of scale. The main argument for free trade rests on an assumed relationship between size of competitive market area and the efficiency and dynamism of the economy.

Why is free trade sought on a regional basis? The explicit aim is the creation of a larger area of free competi-

tion and not merely the reduction of barriers to international trade. More important, a commitment to free trade deprives a country of an important degree of freedom in its domestic policies and also makes it more vulnerable to fluctuations in the economic fortunes of other countries. The disadvantages are reduced if the commitment is undertaken only with countries whose policies are not wholly "foreign". In the relationship between regionalism and multilateralism, it is

> "important to recognize that regional arrangements can accomodate differences in national outlook and in stages of economic development, and thus enable countries to prepare for economic integration on a larger scale, by first adapting to and exploiting the opportunities for economic specialization afforded by arrangements involving relatively homogeneous groups".[8]

Two themes are apparent in the emergence of regional free trading arrangements: (1) the desire for larger markets as a basis for more efficient and rapid industrial development; and (2) the similarity of social and economic philosophy in undertaking the risks and difficulties of such arrangements.[9]

2.2.8 Conclusion

We have seen how industrialization and increased production over the past 150 years have brought with them a desire -- not to say a necessity -- to trade. Few people perhaps realize that 19th century free trade was preceeded by a period where protection of domestic industry was achieved by a total prohibition of imports, where tariffs existed for revenue purposes almost exclusively, and where trade flows were fre-

quently determined by the permission and not only the ability to trade. Seen in this light, the past 150 years shows us a trend towards increasingly freer trade.

The adoption of the policy of free trade by Britain in the 19th century however, coincided with the economic interests of her emerging manufacturing class, and free trade was, in a sense, a means of maximizing her gains from her leadership in the industrial revolution. Other countries anxious to industrialize, resorted to tariffs as a means of promoting industrialization, and Britain in her turn retreated into protectionism under the pressure of increasing international competition in manufactures. Thus free trade in the 19th century appears as an expression of British industrial dynamism.

In an analagous fashion, the initiative for freer trade in recent years has come from the most prosperous and dynamic industrial nations. First, from the United States, the dominant industrial power in the war and immediate post-war period, and more recently from the expanding industrial nations of Europe. In each case, the domestic economic incentive towards freer trade has been to increase the prosperity of an already prospering economy, by expanding opportunities for trade and specialization rather than to stimulate a faltering economy with the incentive of increased international compeition.

One would conclude that:

> "Nations tend to regard free trade as a luxury they can afford if they are getting richer rapidly enough, rather than as an essential for becoming richer more rapidly, as classical theory would have it."[10]

In other words a policy of freer trade promises both rewards to more internationally competitive sectors of the economy and losses to the sheltered sectors. It therefore appears attractive or unattractive according to whether the prospective gains to the competitive sectors outweigh the losses to the sheltered sectors.

"Free trade among industrialized countries,... is not going to be achieved overnight".[11] Should this become the ultimate goal, its success would depend upon the widest possible participation on the part of the industrialized countries of the world. Perhaps, then, we might begin to look beyond the immediate issue of our relationship to the United States, to the Commonwealth, and to the United Kingdom, and in our own national interest, realize that our future lies not only within our borders, but also in North America and in the world at large.

2.3 A Survey of Theory

2.3.1 Introduction

It is intriguing that there has long been a striking divergence between the commercial policies which seem to be suggested by the findings of economic analysis and those followed by most governments.

> "The notion that restrictions on trade imposed by advanced countries usually have an adverse effect on real per capita income is one of the most firmly based conclusions of economics."[12]

However, the obvious generalization to be drawn from a study of the history of commercial policy is that precisely the reverse of the "expert's" recommendations has taken place. In fact, as A.J. Smith noted,

> "there is perhaps no other area in the field of economics in which theorists and practitioners have been so far apart as in the area of trade barriers."[13]

2.3.2 <u>The Case for Free Trade</u>

The theory of the classical political economists served to launch the theory of comparative advantage in international trade. In asserting the reverse of the old mercantilist doctrine, the theory suggests that all nations could gain by international trade out of the greater total world production that national specialization would bring about. "International trade theory essentially urges free trade."[14]

From every important economic assumption a conclusion may be drawn that has some implication for policy; what is surprising is that the policy implication often takes on political overtones and is used by those who have no clear understanding of its derivation. Assumptions about comparative advantage provide good examples. In the classical view, comparative advantage, and thus the direction and composition of trade, depends primarily on "environment". This implies that governments are for the most part powerless to affect their trading relationships since most aspects of the environment-goegraphy, climate, culture, and

social customs -- are well beyond their control, except perhaps in the very long run. When this approach to comparative advantage held the fort, governments indeed seemed to take a fatalistic view of trade and comparative advantage, like technology, was something to be adjusted to, not adjusted.

By contrast, the modern view has comparative advantage depend ultimately on the relative supplies of factors of production to be found within a given country. Correctly or incorrectly, governments commonly reject the immobility assumption of trade theory and attempt now to influence the relative factor supplies by any number of policies ranging from forced savings and interest rate policies, to subsidies for research and education and immigration policies. With the increasing acceptance academically of the modern assumption about comparative advantage, government interest has risen, especially in new countries and semi-industrialized countries, in trade policies, frequently in the form of developmental strategies that are intended to alter in a fundamental way a country's position in the world economy.[15]

The economist's conventional wisdom on the topic of free trade versus the tariff with particular reference to Canada reads as follows: the tariff protects Canadian industry; it therefore allows inefficient high cost production (or efficient high profit production) behind its walls; this raises prices to the Canadian consumer and lowers his real standard of living. The order of magnitude of this social cost is very

probably well in excess of one billion dollars a year. Though there are valid theoretical arguments for tariff protection they are hard to come by, when their assumptions are examined closely, their relevance to the technologically advanced Canadian economy seems slight.[16]

It is evident that there is a close connection between ideology and economic self-interest in matters of trade policy. The classical case for free trade rests on the economic advantages of specialization and division of labour; and the logic of it is independent of a country's stage of economic development.

2.3.3 Criticism

While there appears to be general agreement among economists concerning the benefits arising from a policy of free trade, a dissenting voice in the person of Melville Watkins is heard to take the opposite view.

> "...in a world of tariffs, there is an almost universal commitment of economists to free trade, including its unilateral pursuit. In this fashion, economists tend either to support the status quo by their irrelevance and absurdity, or to contribute to the further disruption of a world that is already out of control."[17]

Watkins is joined by many others equally vehement in their opposition to the case for free trade. To illustrate the gulf between the conventional wisdom of economists and the conventional wisdom of politicians, we call on Sir John A. Macdonald who attacked the case for free trade on political grounds:

> "There are national considerations, Mr. Speaker, that rise far higher than the mere accumulation of wealth, than the mere question of trade advantage, there is prestige, national status, national dominion, and no great nation has ever arisen whose policy was Free-trade."[18]

Macdonald spoke of many of the issues which were to be raised in future arguments surrounding the free trade controversy.

J.H. Young in his critical examination of the economic case for freedom of trade felt that the theory may be criticized at two levels: (1) either the economic analysis on which the case is based is erroneous and therefore suggests wrong conclusions; or (2) even though the applied theory of trade can show that tariffs and other restrictions involve economic costs, these should be accepted in order to achieve social and political objectives which are regarded as worth the costs involved.[19]. There is a close similarity between the discussions of this issue which occur today and those of past years. It has not seemed possible to reach a conclusion or even a consensus.

Protectionists cite as evidence for their cause, the case of the very successful and very protected American manufacturing industry through most of its history. Free traders on the other hand, point to the prosperous and free trading United Kingdom during the mid-19th century. The problem concerns the economic analysis underlying the case for free trade.

Other things being equal it is suggested that real per capita income will generally be lower than it would have been if trade restrictions had not been imposed. The relevant

comparison is therefore between the economy as it has become with tariffs or other barriers and the economy without. Unfortunately, the economist is unable to perform controlled experiments, reliving a period of economic history while changing one of the variables. As a result, reliance must be placed on evidence of an indirect character.

The economic case for free trade thus cannot be attacked by simple reference to the conditions of the real world. Attacking the theory must then involve an examination of the internal logic on which it is based, and a critique of the assumptions which are at the foundation of the theory. It is important to keep these two aspects of the theory separate, as many of the assertions commonly presented in defense of trade barriers can be shown to be erroneous if the ordinary assumptions of trade theory are accepted. For example, it is often asserted that tariffs increase employment, that they increase income by excluding the products of cheap foreign labour, and that they ensure balance of payments equilibrium. Dales notes ruefully that

> "international trade theory has failed conspicuously to provide any check on the long-run 'theorizing' of the man in the street and in government."[20]

From the point of view of the internal logic of the economic theory underlying the economic case for freer trade, the basic notion involved is so simple and obvious that there is little room for logical error. Trade is voluntary and thereby will not be carried on unless it is mutually profit-

able to those so engaged. Trade barriers prevent such mutually profitable transactions and thus can be expected to reduce economic welfare. It should perhaps cause a certain amount of surprise that a complicated theory of international trade is neccessary to provide a proof of such an obvious common sense proposition. In the case under discussion, if appropriate assumptions are made, the common-sense approach does not require any substantial modification for rigorous analysis yields the same conclusion.

While the economic analysis underlying the economic case for free trade appears free from logical errors, the assumptions on which the analysis is based may be open to criticism. The most effective attacks on freer trade arguments have therefore been those which attempted to prove the irrelevance of the theory by attacking its basic assumptions.

2.3.4 Free Trade vs. Protectionism

The most conspicuous and time-honoured policies to restrict competition are the tariff and other measures designed to protect domestic producers from foreign competition in home markets. The logic of the private-enterprise, free-market model upon which the Canadian economy is commonly held to be based makes no provision for tariffs or other barriers to free trade. David Ricardo, a 19th century economist wrote:

> "The sole effect of high duties on the importation, either of manufactures or of corn or of a bounty on their exportation, is to divert a portion of capital to

> an employment which it would not naturally seek. It causes a pernicious distribution of the general funds of the society -- it bribes a manufacturer to commence or continue in a comparatively less profitable employment."[21]

The relevance of these principles of free-market economics to the situation of a young developing country could, of course, be challenged. It was contended several hundred years ago that the state should protect newly created industries from foreign competition in order that they get established. Such a policy of protection found great favour in the eyes of manufacturers operating in Canada struggling to industrialize under difficult conditions in the late 19th century and this period marked the official declaration of Canada's rejection of free trade and the adoption of protectionism as part of the grand strategy for Canadian development. The debate on free trade versus protectionism in this country subsequently has been between Canadian manufacturers in central Canada and spokesmen for the Western and Maritime provinces, the latter enlisting the aid of academic economists.[22]

Permeating all the specific issues of policy arising from Canada's current international trade problems is the general issue then of free trade versus protection of secondary industries as the guiding principle of policy. As we have seen above, this is an old issue in international economic policy and the arguments currently being advanced in favour of greater protection in Canadian industry are thoroughly traditional. John Young commented on Tilley's introduction

of the National Policy in the Budget Speech of 1879 as follows:

> "There are few well-known erroneous economic arguments for protection which Tilley did not manage to include somewhere in his speech."[23]

Despite the fact their illogicalities and inconsistencies have been exposed so often, "This does nothing to diminish the enthusiastic conviction with which they are repeated".[24] Thus growing protectionism elsewhere is assumed to require increased protection in Canada, though the benefits of free trade to a country do not depend on other countries practising it.

Arguments promoting protection are also formulated from the historical point of view. For example, the Canadian Manufacturing Association asserts that:

> "History has shown that no country has been able to create a well-balanced and prosperous economy without establishing and maintaining a tariff policy which provides for customs tariff rates and duty valuations designed to develop and maintain the agricultural and industrial production, as well as to protect the people and capital engaged in various forms of enterprise."[25]

In other words, the tariff is said to have been essential to the preservation of the Canadian manufacturing sector and hence to Canadian prosperity. Without protection from American competition, Canada would have been doomed long ago. A belief in this proposition has been built into Canadian public opinion by the writers of the history of Canada. However, these historians have shown a pointed disregard for contrary evidence. Canada was industrialized before the National Policy was conceived, and the National Policy had no

discernible effect on Canadian growth for its first 20 or 30 years. Canadian growth therefore is quite easily explained by other factors (i.e., the 'closing' of the American frontier, rising world prices, falling shipping rates, the development of the gradual reduction process for milling wheat, and the development of the technique of making paper from pulp wood, none of which owe anything to the National Policy).[26]

While free traders point to 19th century Britain, protectionists cite the case of 20th century America, both using an historical period as an example of prosperity resulting from a particular trade ideology. Historical arguments, apart from their relevance to today's international economy, are seen to be contradictory to say the least.

At the heart of the controversy on protection are the difficulties in moving from the cash cost to the economic cost of the tariff. Direct price effects leading to the cash cost of the tariff are indisputable but it is frequently argued that even though consumers of protected products pay more, the country reaps economic benefits which more than offset the extra costs entailed by the existence of the tariff.

Many of the arguments intending to show economic benefits deriving from tariffs once again may be recognized as erroneous by reference to basic economic principles, but at times there are conditions under which they have some merit. The Canadian economy is so obviously dependent on trade that proponents of protection are forced to agree that free or freer

trade confers an economic benefit. But they go on to argue that in the case of present day Canada, there are special reasons why trade barriers confer economic or quasi-economic benefits.

2.3.5 Infant Industry

There are those who argue that insufficient account is taken of the process of economic development. It is fine for a theory to assume a given technology, a given supply of factors of production, full employment, free competition both domestically and internationally, mobility of resources, and the rest. And it is quite true that given these assumptions, it can be rigorously demonstrated that a country's income will be higher at a given point in time without trade restrictions than with them. But it may be possible, say the protectionists, by providing assistance to selected industries, to encourage their growth and the economic growth of the country as a whole.

In other words, a country may be well suited to the production of a particular commodity which is currently being imported but because foreign producers are experienced and well-established, there may be a reluctance on the part of businessmen to start or expand the domestic production of the commodity. It is argued that under these circumstances, the government should be prepared to grant the domestic industry temporary protection, the protection to be withdrawn when the domestic industry can meet foreign competition without assist-

ance. While the economy may be poorer temporarily enhanced economic growth would mean higher living standards in the future, and within a few years, the country may be better off than it would have been in the absence of trade barriers. This proposition is known as the "infant industry" argument for protection.

This argument has a long and interesting history. Adam Smith in his "Wealth of Nations" had little sympathy for it but later some economists took the opposite view. List and A. Hamilton both argued in favour of protection. Rather than an infant industry argument however, both were arguing for assistance to a broad range of manufacturing industries in countries in the process of transition from an agricultural to an industrial economy. As is the case for some of those concerned with underdeveloped economies today, they were defending assisted industrialization rather than highly selective aid for particularly promising industries. It was, in short, a young economies rather than a young industries argument.

It was recognized in economic theory that the case for young industry protection had particular application to young or underdeveloped countries, but in the writings of some economists, this same argument became one for highly selective assistance to particular industries rather than a case of assisted industrialization on a broad scale. This latter form of argument is less convincing because special reasons

must be advanced to explain both why a potentially profitable type of production is not undertaken when there is ample entrepreneurial talent with access to capital and no lack of technical personnel and why a particular type of production which fails the free-market test should be regarded as a worthwhile project for government assistance.

Another economist, John Stuart Mill, while admitting the validity of the case for protection in certain instances, went on to say:

> "...experience has shown that Protectionism, once introduced, is in danger of perpetuating itself through private interests it enlists in its favour, and I therefore now prefer some other mode of public aid to new industries..."27

Many later economists have shared Mill's attitude.

Whether one is pro or con free trade, it must be recognized that protection involves a cost. If it could be shown that the existence of the industry conferred a benefit on other industries for which no payment was received, this would constitute an offset to the cost. This latter point, referring to the external economies arising from particular industries, generally has been regarded as the principle raison d'etre of infant industry assistance. There are some who have argued that the creation of technicians and entrepreneurs is so important in economic growth, that a policy of this kind may prove to be successful in underdeveloped countries. But it would generally be agreed that conditions in advanced countries, including Canada, differ fundamentally from those encountered

in less developed countries.

In fact, with regard to availability of technology, capital, and entrepreneurial talent, Canada is in a position not differing greatly from that of American industry. Where the Canadian situation differs is with respect to unrestricted access to the large U.S. market. This argument will be advanced in favour of free trade with the United States in later chapters.

Of course, some exceptions would still qualify for temporary assistance, even in Canada. For example, some regions of the county have lagged in economic development, and because of population immobility, income differences have developed and been perpetuated. It has been suggested that some temporary aid be provided to particular industries locating in these regions as part of a general scheme of regional assistance. In this case it is urged that direct subsidies be used in preference to tariffs since they: (1) keey down the price of the final product, thereby assisting industry in obtaining larger markets; (2) provide a more accurate record of costs involved; (3) are more effective in influencing location of industry; and (4) require annual government review.[28]

In summary then, it seems unlikely, unless serving other aims than those of economic development, that many significant opportunities will arise in an advanced country such as Canada, in which it will prove worthwhile to subsidize types of production, which do not meet the normal tests of the market, under

the guise of protection and by the means of tariffs. Some of the oldest industries in Canada were originally infants requiring the protection of the tariff. Most still enjoy substantial tariff protection and virtually all argue this is necessary and even that it should be increased. "The period of their 'infancy' is not only protracted, it bids fair to become permanent."[29]

2.3.6 <u>Terms of Trade</u>

Another qualification often applied to the free trade position is the effect that trade barriers have on prices of goods and services a country buys and sells, the "terms of trade" argument for a tariff.

The amount of purchases and sales a country makes will ordinarily have some effect on the prices at which it exports and imports. A reduction in its purchases and sales because of the introduction of trade barriers may be thought to lower the prices of the things it buys and to increase the prices of the things it sells. Some countries, sufficiently important as buyers and sellers that a change in the quantity of their purchases on sales may, at least in the short run, have a significant effect on world prices, can exploit their power as buyers and sellers and may thereby gain some short run advantage at the expense of other countries. Although this has received some attention in theoretical discussions in the past, it is extremely doubtful if considerations of this kind

have played a role of any importance in tariff-making.

In general, "theoretical arguments would appear to have been of very doubtful persuasive value to policy decisions, at least during recent decades".[30]

It is also argued that because other countries are unwilling to lower their trade barriers, it is thus in Canada's interest to retain or increase existing Canadian barriers. This argument, with particular reference to the United States, has always figured prominantly in Canadian tariff history. However a country generally will gain by reducing its own trade barriers regardless of the actions of other countries. If a single small country such as Canada is involved, the effect of its policies on world prices is likely to be small; it is thereby unlikely to adversely affect its 'terms of trade' with other countries. For a country in this position, the general principle applies that it will benefit over the long run from a reduction in its own tariff, even if the reduction is a unilateral one. Similarly it is in its long run economic interest to retain low barriers, even if other countries choose to raise theirs.

What makes little sense in terms of long run economic interests may make more sense in terms of short run economic and political considerations. The reduction of a tariff may pose considerable political problems the possible short run consequences of which are not always solely political in nature. The gains from tariff reductions are not likely to

materialize immediately and if the reductions are sufficiently widespread and substantial, some short run adverse economic effects are to be expected. However if the depressing effect of such reductions on some protected industries can be offset by the expansionary effect following any reciprocal tariff reductions in other countries, the adjustment process will be eased.

And of course, insofar as a country's terms of trade are sensitive to changes in commercial policy, a reciprocal reduction enjoys a considerable advantage over a unilateral one. In addition, negotiating considerations often suggest the retention of tariffs as bargaining power able to be used in obtaining reciprocal reductions. It is not surprising then that the actions of other countries, particularly the United States, can have a significant effect on Canadian tariff policy.[31]

2.3.7 Employment

When the full employment assumption of the free trade argument was not satisfied during the Depression of the 1930's, it seemed evident that by restricting the supply of imported goods, employment at home would be stimulated. This would indeed be the result over the short run if such a course of action was restricted to a single country. By creating trade barriers, perhaps devaluing its currency, any one country could improve its competitive position by exporting some of

its unemployment to other countries. These are referred to as "beggar my neighbor" policies and gains of this kind are likely to be short-lived.[32] Unfortunately they quickly lead to retaliation all round making all countries worse off. After passing through a decade characterized by practices of this kind, international agreements were sought establishing the I.M.F., the I.B.R.D., and GATT, and aimed at preventing a recurrence of such activities.

However the proposition that a tariff adds to employment merits further consideration. The tariff clearly promotes the employment of resources in a protected industry, and it is thought that this employment constitutes a net addition to employment in the economy as a whole. The extreme opposite of this assumption is frequently made in international trade analysis where it is often assumed that full employment exists both before and after the imposition of a tariff and that a tariff merely leads to a reallocation of employed resources rather than to an increase in employment. With regard to the last 25 or 30 years, the full employment assumption is clearly the more correct since this condition has been the rule with short periods of cyclical unemployment. The level of employment is more determined by the government's fiscal and monetary policies than by its commercial policies.[33]

2.3.8 Relevance

The criticisms enumerated above, all fairly pointed in

nature, draw attention to the weakness of specific assumptions of the free trade theory. It is also argued that although the 19th century provided economic conditions like those envisaged by the theory of trade, this is no longer the case in the "administrative" economies of today where we have large corporations, powerful trade unions, and farm support policies, rather than free trade, flexible prices, mobile resources, monetary systems linked by the gold standard, and limited government activities. Consequently the case for free trade is said to be outdated.

This argument, which exaggerates past and present differences, has little relevance in North America in general and in Canada in particular. Over much of the Canadian economy, the issue is clouded as to whether or not markets are as free or freer than they were fifty years ago; nevertheless, the country has in recent years demonstrated a capacity to adapt successfully to new circumstances as they have arisen. A robust confidence in the capacity of a free market to bring about adjustments to new conditions is much more a characistic of current Canadian economic thought than that of most other countries despite recent uprisings of protectionism and narrow Canadian economic nationalism.[34]

2.3.9 Population

One more argument urging protection deals with the connection between the tariff and the population sustaining capa-

city of the Canadian economy. It is asserted that the tariff creates job opportunities, greater employment in turn encourages immigration and discourages emigration, and this in turn promotes a higher rate of population growth. Since secondary industries are more labour-intensive than alternative types of employment, encouragement must be given to their expansion by the tariff to provide employment opportunities for a rapidly growing population.

Given the magnitudes involved (i.e., the cost of the tariff -- see Chapter IV) there is more reason to suppose that the tariff has lowered rather than raised the return to labour in Canada. One has only to note the differences in wages in Canada and the United States, much of which may be attributed to the trade barriers existing between the two countries. Whatever the answer may be, there is general agreement that if a transfer of income to labour is desired, it can be accomplished at less economic cost by appropriate taxes and subsidies.

While much emphasis is placed on the population sustaining argument at present, a reference to the recent history of Canada's population growth would suggest that this emphasis is misplaced. Changes in tariff policy can have little effect on the real determinants of immigration; that is, immigration policy, and the availability of immigrants. Neither can any significant gain in population be expected from any effect of tariff policy on emigration if the post-war

figures are any indication showing the flow as being insignificant when compared to the late 19th century and early 20th centuries.

Therefore it is most difficult to see the connection between population growth and commercial policy as reflected in tariff levels. In the past, with unrestricted immigration and large-scale emigration, the influence of the tariff on population size, whether positive or negative, raised a significant question. In the light of what has been said about the present determinants of Canadian population growth, this connection can have little practical importance today.[35]

2.3.10 The Canadian View

In Canada, arguments for protection have arisen over many issues both before and since this nation was first conceived. Canadians have not been in any way immune to the call of economic nationalism whether the response came either from the manufacturers or from the politicians. There are even those who assert that protection will not raise prices because a larger volume of domestic production will lead to a lowering of costs. This argument neglects to explain however, why competition and the quest for larger markets does not lead domestic producers to lower costs in the absence of increased protection.

Two other arguments have been advanced, both of particular relevance to the Canadian scene. The first holds that

since present Canadian tariff policy was devised when American competition was the main threat to be guarded against, the government has an obligation to adapt it to provide more protection against the new and unanticipated threat of Japanese and European competition. This argument assumes that the government has undertaken a commitment to protect Canadian industry against foreign competition to a degree which the tariff has ceased to provide under present circumstances, an assumption which may or may not be jusitified.

The second argument contends that Canadian national independence requires the existence of more Canadian industry than would be able to survive under free trade. This argument entails recognition of the fact that "a political objective is being sought at an economic cost"[36] (the cost of being Canadian!). Sir John A. Macdonald cited many of these political objectives earlier when he made his plea for a National Policy. As A.J. Smith indicated in his discussion of Canada's policy problems,

> "In the final analysis, political and other non-economic factors, coupled with only rather broad and vague economic considerations, appear to determine whether a country will have higher or lower trade barriers."[37]

This raises two questions: (1) what precise contribution does a larger secondary industry make to the maintenance of national independence; and (2) how much is it worth to the country to pay for this contribution? H.G. Johnson points out very clearly

"the conflict in Canadian thinking between the <u>economic</u>

> considerations favouring closer economic integration with the United States and the political fear of American domination and loss of Canadian national identity."[38]

2.3.11 Conclusion

With the list given above of possible exceptions and criticisms, it was not meant to convey the impression that little remains of the economic case for freedom of trade. In many cases, the exceptions are quite unimportant, and in others, they provide reasons why it is both easier and more profitable to move in the direction of freer trade by reciprocal agreements with other countries rather than by unilateral action. Much remains to be said however with particular reference to Canada's position in matters of commercial policy, protection and tariffs, and freedom of trade; these matters will be covered in some detail in the ensuing chapters.

2.4 Footnotes

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25. Canadian Manufacturer's Association, Submission to the Canadian Tariffs and Trade Committee, (May, 1964), Appendix A.

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27. Letters of John Stuart Mill, Ed., H.S.R. Elliot, Vol. II, Written July 5, 1968, p. 117.

28. Young, J.H., op. cit., pp. 5, 77-89, 15.

29. Gordon, H.S., op. cit., p. 25.

30. Smith, A.J., op. cit.

31. Young, J.H., op. cit., pp. 5, 77-79, 15.

32. Ibid., pp. 6, 75-76.

33. Johnson, H.G., op. cit., p. 77.

34. Young, J.H., op. cit., pp. 6-7.

35. Ibid., pp. 77-93.

36. Johnson, H.G., _op_. _cit_., p. 78.

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CHAPTER III

HISTORICAL PERSPECTIVE OF THE TARIFF IN CANADA

3.1 Introduction

This chapter, as part of the background analysis of this study, is devoted to some of the outstanding features of the history of the Canadian tariff from pre-Confederation days down to the present. There has been a marked continuity in Canadian commercial policy and 19th century developments have tended to be held over to a large extent in the 20th century.

An examination of the Canadian tariff reveals no strictly logical explanation for either its level or structure. There is, however, an historical explanation for both the level and the structure. Every section of the Customs Act and every phrase and rate in the Tariff Act has an historical background. Even those parts of the tariff which are relatively new are usually substitutes for older sections and schedules. Of course it is not possible in this chapter to give a comprehensive balanced account of Canadian tariff history and no attempt will be made to do so. The search for origins of particular aspects of the Canadian tariff would have to go back to the commercial history of France and Great Britain to find the sources of the controls on colonial trade when Canadian commercial policy was determined in Europe.

A convenient break in historical processes is evident in the 1840's with the passing of the old preferential arrangements between the Colonies and Great Britain and the granting of a measure of autonomy to the colonies in forming their own trade policy. Continuity has become one of the outstanding characteristics of Canadian tariff history and between the late 1840's and Confederation, all the principle elements which were to play a part in the tariff history of Canada for the next century appeared: British preference; reciprocity with the United States; revenue needs; and protection for secondary manufacturing.[1]

3.2 A Survey of History

3.2.1 Introduction

The initial purpose and effect of the protective tariff together with the national transportation system as part of the national policy, was to establish an East-West trading relationship involving a considerable degree of regional economic specialization. The manufacturing and industrial core of the country developed in Ontario and Quebec with a strong primary resource orientation in the other regions. How much this broad historical picture of regional patterns might have been altered by a basically different commercial policy cannot be known. But as a determinant of present day policy, and as a prelude to

future policy, historical trends as they appear in Canadian commercial policy are revealing to say the least.[2]

3.2.2 Tariff Ratios

The main problem in attempting to analyze tariff variations over the years is finding a suitable technique to measure these complex changes. Until now, no completely satisfactory method has been discovered. One method which has come into broad acceptance however, involves the use of ratios and employs the relationship of import duties collected to import values. In fact two ratios are constructed: one the ratio of duty collected to total imports; the other the ratio of duty collected to dutiable imports.

Nevertheless these ratios are misleading as indicators of the average "height" of a tariff since commodities bearing low rates are over-represented and those bearing high rates are under-represented. For example, a tariff made up of a free rate and a set of prohibitive rates would have a ratio of duty collected to total imports of zero, although it might be a highly protective tariff. The ratios are of some use however, in the tracing of historical changes.

3.2.3 The Level of the Tariff

The following charts are displayed in an attempt to chronicle the major changes in the tariff in Canada from pre-Confederation years up until our more recent past. Only

TABLE 3.1

TARIFF RATIOS FOR THE PROVINCE AND THE

DOMINION OF CANADA, 1847-1939

Year	Ratio of duty collected to dutiable imports	Ratio of duty collected to total imports	
1847	11.7	11.5	
1848	10.8	10.5	
1849	16.3	14.8	-- tariff increases
1850	15.6	14.5	
1851	14.9	13.8	
1852	15.5	14.6	
1853	13.6	12.9	Reciprocity Treaty with United States--
1854	13.0	12.1	-- transfer of number of commodities from
1855	13.7	9.8	dutiable to free list only
1856	14.2	10.3	
1857	14.5	10.0	
1858	16.3	11.6	-- Cayley Tariff
1859	18.9	13.2	-- Galt Tariff
1860	19.9	13.8	
1861	19.1	12.0	
1862	19.4	10.1	
1863	22.5	12.5	
1864	21.9	13.6	
1865	22.4	14.2	tariff reduction in anticipation of
1866	22.0	15.3	-- Confederation in deference to the
1867	19.6	13.3	Maritime Provinces
1868	20.2	13.1	
1869	20.2	13.1	
1870	20.9	14.1	

TABLE 3.1 (CONTINUED)

Year	Ratio of duty collected to dutiable imports	Ratio of duty collected to total imports	
1871	19.6	14.0	
1872	19.1	12.4	
1873	18.3	10.4	-- Changes minor--ratios stable
1874	18.9	11.7	
1875	19.6	13.1	
1876	21.3	13.9	
1877	20.6	13.3	
1878	21.4	14.2	
1879	23.3	16.4	-- National Policy Tariff of 1879
1880	26.1	20.2	
1887	28.7	21.3	
1888	31.8	22.0	-- further increases and falling prices
1890	31.0	21.8	
1896	30.0	19.2	
1898	29.7	17.5	minor reductions--introduction of
1900	27.7	16.7	-- British Preference unilaterally
1908	26.6	16.5	
1913	26.1	17.1	-- ratios stable--slight reductions
1925	23.3	15.1	tariff increases--Depression
1929	24.4	15.8	
1933	30.1	19.0	-- Bennett Tariffs 1930-31
1936	26.7	14.7	-- Canada-U.S. Trade Agreement
1939	24.2	13.8	-- retreat from high level started back to level of late 1920's

Source: Young, J.H., Canadian Commercial Policy, (Ottawa: Queen's Printer, 1958), pp. 23, 24, 33.

changes which spelled out a significant effect on the level of protection in Canada are presented and the limitations of the use of ratios must be kept in mind. The ratios often reflect the combined influence of several factors including changes in *ad valorem* rates of duty, movements in import prices affecting the *ad valorem* equivalents of specific rates, changes in the composition of trade, and shifts in the origin of imports.[3] In effect ratios point in the direction of the change but are an inaccurate measure of the extent of the change.

TABLE 3.2

TARIFF RATIOS, CANADA, SELECTED YEARS, 1870-1955

Year	Ratio of duty collected to dutiable imports	Ratio duty collected to total imports
1870	20.9	14.1
1880	26.1	20.2
1929	24.4	15.8
1939	24.2	13.8
1946	21.2	11.9
1949	17.4	9.1
1953	18.6	10.2
1954	18.1	10.2
1955	18.2	10.2

Since 1939--level declined approximately 25% --present tariffs somewhat below historial level.

Source: Young, J.H., *op. cit.*, p. 49.

In an account of the development of the Canadian tariff in a short space, a few generalizations are by necessity going to be included. Perhaps the most obvious is the remarkable stability of the Canadian tariff over the course of the last century. There are only three occasions on which the tariff has been significantly raised: the Cayley-Galt tariffs of 1858-59; the National Policy of 1879; and the Bennett Tariffs of 1930-31. It is worth noting that on each of these occasions, the economy was undergoing a depression or had just emerged from one.

Reductions in the tariff were ordinarily spread over longer periods. The tariff of central Canada was reduced somewhat at Confederation in deference to the Maritimes, there was some downward tendency under Liberal governments in the period 1896-1911, and in the 1920's, and there was a fairly substantial reduction when the depression hikes of the early 1930's were undone by a new government and the reductionscarried further in the post war years.

Since 1939, a number of rates have been reduced and specific rates that have remained fixed have had their protective value stripped considerably by price increases. Since ratios reflect reductions in revenue rates as well as shifts in the origin of imports and changes in the composition of trade, they do not accurately measure what could be termed changes in the overall level of protection. While they show a decline of about 25% between 1939 and 1955, few of the

important protective rates of the Canadian tariff have been reduced to this extent, while others have not been reduced at all.

Price increases have marked effects on the *ad valorem* equivalent of specific rates, but items bearing *ad valorem* rates are unaffected by price changes. Thus it is seen that a variety of factors influence the ratio of duty collected to total imports, similarly of duty collected to dutiable imports. A change in the rate on an item not produced in Canada has an effect on revenue but a minor effect on protection. By the same token, a change in a rate not being fully utilized may have a relatively insignificant effect on either prices or the allocation of resources. And the effect on prices and the allocation of resources is the key test. Unless the reduction of a tariff rate lowers prices and pushes resources out of that segment of the domestic industry producing the commodity, or discourages the entry of resources into that portion of the industry, or stimulates improvements in productive techniques and management, then the rate change has not reduced the protective effect of the tariff.

On this basis, Canadian tariff reductions since 1939 are unimpressive.

By way of conclusion, it may be said that ratios of duty collected to total or dutiable imports tend to exaggerate the extent of the reduction in the protective effect of the

tariff. However, some of the protective effect was in fact decreased by price increases, rate reductions, and changes in customs administration of the period. As a result present Canadian tariff rates are generally somewhat below their historical level.[4]

3.2.4 Recent History

Following World War II, Canada played a leading role in the first search for multilateral reduction of tariffs but reconstruction shortages in Europe called for other priorities, exchange controls, and quotas. Nevertheless, the General Agreement on Trade and Tariffs in 1947 established the principle of non-discrimination, embodying it in the generalized most-favoured-nation clause. The members then turned to: (1) a systematic elimination of quantitative restraints on trade; and (2) successive tariff reductions.

Since that time, tariff negotiations have depended primarily upon American leadership for several reasons. Firstly, North American exports were the mainstay of reconstruction, and secondly, the realization of recovery required American acceptance of the products of European industry. By the end of the fifth round of negotiations under GATT in 1960-62, negotiators, especially those of Canada and the United States, felt that any further tariff cuts would require more basic readjustments of protected industries.[5]

Economists have noted and the politicians are most certainly aware that the most protective element of a tariff is probably to be found in the last few percentage points. When one emerges from a period of rising protection and achieves tariff reductions, the first cuts will simply remove some of the "window-dressing" from inflated positions intentionally built up for negotiating purposes. Successive reductions will go to the heart of the tariff only in time. Apart from this, the lower a tariff becomes, the greater is the intangible expense in time and effort of passing customs in relation to the duty paid. It is perhaps of particular significance that E.F.T.A. trade began to expand substantially only when the last 20% cut was made in the intra-area tariffs in 1966. Similarly, significant trade creation and re-allocation of factors on a world basis will probably be prevented until the present barriers to trade are largely eliminated.[6]

The most significant single development in international trade since the war was the inauguration of the Treaty of Rome on January 1, 1958 and the birth of the E.E.C. This event ushered in the era of regionalism under common market or customs union or free trade areas as opposed to multilateralism under GATT. When in July, 1961, the United Kingdom applied for membership in the EEC, one of the foundations of Canadian trade policy was badly shaken and the implications for Canadian trade were numerous. Underlying Canada's fear

of her second largest customer abandoning the Commonwealth Preference system was the Canadian government's attitude to the role of British Preference in relation to Canada's dependence on the United States.

An appreciation of the need for rationalization or increased specialization in Canadian manufacturing has recently brought some Canadian economists to recommend that the Canadian government arrange free trade with the United States and perhaps with other countries either on a wide scale or for the products of particular industries. This idea has come into recent favour because it is recognized that there are some industries, such as those producing sources of energy, for which the North American market is effectively separated from Europe so that even if Canada and the United States had to grant free access to their markets on an m.f.n. basis, it would make little difference except to trade within North America. This suggestion is also the result of growing recognition among Canadian manufacturers that tariff reductions under GATT are unlikely to provide them with the free access they require before they can confidently adapt their production facilities to specialized export rather than maintain diversified and less efficient production for the domestic market.

The most important accord concluded to date was the U.S.-Canadian auto agreement announced January 15, 1965. Under this agreement, the American and Canadian governments

agreed to eliminate tariffs on trade in automobiles and components, although on the Canadian side, tariff removal covered only imports by so-called "eligible" automotive producers. The success of this agreement, especially from the Canadian point of view, has been nothing less than spectacular and automobiles and related parts are now Canada's leading export. The accord permitted Canadian producers to restructure their production in order to become a specialized supplier of the North American market.[7]

While such a unique arrangement has perhaps little relevance for other industries, some government spokesmen have hinted at other schemes of a similar nature. The most recent to make headline news is the current proposal of a continental energy policy between Canada and the United States. While these schemes are by nature less all-encompassing than an envisaged North American Free Trade Area, they are no less important concerning their repercussions on the Canadian economy. These matters will be dealt with in greater detail in a later chapter on free trade between the United States and Canada.

3.2.5 British Preference

Preferential treatment for goods from Commonwealth countries has been a feature of the Canadian tariff throughout much of Canada's history. In the mid 1800's, with Britain holding strong views on free trade, the old preferential

arrangements between the colonies and their mother country came to an end with nothing to replace them for thirty years. Economic problems of the period including the removal of preferences, a general economic depression, and political disturbances led to great difficulties in Canada.

Following the introduction of the National Policy in Canada, mainly as a result of her economic woes, there were two major periods of change in British Preferential arrangements: (1) from 1897 to 1900 when the Preferences were re-introduced; and (2) the 1930's when the preferential margins were widened and then narrowed under trade agreements negotiated in the middle and late thirties. From the inception of the National Policy in 1879 to the end of the 19th century, Canada attempted to regain her preferential position in Britain in exchange for Canadian concessions. Finally in 1896 preferences were extended unilaterally to Britain. The traditional free trade policy of Great Britain was maintained until 1931-32 when the tariff was established covering a major proportion of British trade. At this point the U.K. once again granted concessions to Canada and the other Commonwealth countries. Since then the preferential arrangement has been reciprocal in nature.

Even the preferential arrangements were unable to halt the decline in trade between Canada and Great Britain and the increase in trade between Canada and the United States. This constituted a basic shift in the origin of Canadian

TABLE 3.3

PERCENTAGE OF CANADIAN TRADE WITH U.S., U.K. AND REST OF WORLD

	U.S.		U.K.		Rest of World	
	exports to (%)	imports from (%)	exports to (%)	imports from (%)	exports to (%)	imports from (%)
1896-1900	28	57	60	27	12	16
1926-1929	38	67	35	16	27	17
1947-1950	51	71	21	11	28	18
1957-1958	60	70	15	10	25	20
1963-1965	55	69	14	7.6	31	23.4

Source: Wonnacott, R.J., Canadian-American Dependence, (Amsterdam: North-Holland Publishing Co., 1961), p. 5; and Wilkinson, B.W., Canada's International Trade: An Analysis of Recent Trends and Patterns, (Canadian Trade Committee, 1968), pp. 30, 40.

imports and in the destination of her exports.

Most of what was done in the 1930's has since been undone and the period ended with a reduction of the Canadian tariff accompanied by a narrowing of preferential margins.

Since the Second World War, GATT was introduced by which it was agreed during negotiations that countries should not be required to eliminate preferences, but that their

importance should be reduced in international trade. No new preferences were to be created, no existing preferences were to be enlarged, and all remaining preferences were to be negotiable.

Preferential rates are, of course, relatively less important at present when only 7% of Canadian imports come from the United Kingdom, than they were forty years ago when this porportion was twice as high.[8]

More recently, Britain has once again applied for admission to the E.E.C. If she is successful in her bid, some economic repercussions will certainly be felt in Canada. The first source of strain would undoubtedly be felt by Canada's agricultural exporters; the second would entail implications for Canadian export of manufactured products, both in Britain and in the presently-constituted Common Market. If Canada suffered trade discrimination in favour of intra-European trade, this could very probably spell the end of the long history of the Commonwealth Preference system.[9]

3.2.6 Revenue Considerations

In these days of high corporate and personal income tax when revenue from customs duties provides less than 10% of total federal receipts, the revenue consequences of tariff changes tend to be ignored. This was not always the case. Until the last two or three decades, revenue was an important

factor in Canadian tariff policy.

In 1860, 60% of ordinary revenue for the Province of Canada came from customs duties. In the first decade after Confederation, they provided 75% of federal government receipts. The need for revenue in this early period helped to establish the tariff habit in Canada. It facilitated the move by stages from a tariff for revenue only to a tariff providing for incidental protection, to a tariff designed primarily for protection. Moreover, in periods of depressed economic conditions, when imports and consequently revenue fell, arguments for protection were certain to be well-received by governments anxious to reduce their deficit.

Even from the National Policy tariff to the eve of World War II, revenue considerations played a role in the determination of policy. In 1929 for example, customs duties furnished 40% of federal government receipts. A link between the treasury and protected industries was established and continued to block opposition to the tariff in the years that followed.

Following the last great war, the tariff factor diminished in importance, becoming nothing more than a traditional and accepted source of revenue with the development of alternative methods of taxation. Thus, revenue consequences of tariff changes no longer play any significant role in the determination of tariff policy.[10]

3.2.7 The Birth of Protection in Canada

While revenue considerations once played a major role in the determination of tariff policy, there was no absence of simultaneous demands for protection. The first organized group to achieve historical prominence was the Association for the Promotion of Canadian Industry formed in 1858. The members argued as follows in their petition:

> "That...the difficulties now experienced by all classes of the community are, in a large degree, the consequence of the unfair competition to which the present tariff of the Province exposes its various branches of industry; and that with a view to the promotion of general prosperity, a re-adjustment of the scale of duties levied upon imports has become an absolute necessity."[11]

The APCI was succeeded by other organizations which continued to press for higher tariffs, and which played a prominent role in suggesting schedules for inclusion in the National Policy Tariff of 1879.

In one of the best presentations of the case for Canadian protection ever made, Sir John A. Macdonald with his famous resolution of 1878 called for a National Policy which by "a judicious readjustment of the tariff" would benefit and foster the agricultural, mining, manufacturing, and other interests of the Dominion, retard emigration to the United States, restore prosperity, prevent the dumping of foreign goods in Canadian markets, encourage interprovincial trade, and provide a bargaining weapon for tariff negotiations with the United States.[12]

The National Policy introduced broad political factors

into the tariff controversy. While in later decades the main bulk of the controversy of the tariff has concentrated on economic effects, particularly its effect on export-oriented regions and industries, at all the crucial turning points in Canadian tariff history, political considerations tended to overshadow economic ones. The Canadian economist J. H. Dales commenting on the National Policy stated:

> "As for the tariff, Macdonald rang all the changes on the protectionist fallacies and promised that his tariff would benefit everyone, the teaching of the dismal science notwithstanding. Macdonald was the first great Canadian non-economist."[13]

Following the higher tariffs instituted under the National Policy, and the adjustment made in the economy, resistance to major change became very strong. The Canadian historian A.R.M. Lower bluntly refers to the National Policy as being a "frank creation of vested manufacturing interests living on the bounty of the government."[14] With the introduction of the British Preferential tariff, the central issue of protection versus freer trade was evaded, and the hard core of protection in the Canadian tariff remained intact.

In the period following the Depression there has been no serious departure from the policy of protection for Canadian industries. Because of the height or the products involved, most tariffs can be reduced without a significant effect on protected industries.[15] And with the formation of the EEC, and EFTA, regional arrangements have begun to predominate as pointed out above by H. G. Johnson.

Thus while the revenue consequences of tariff changes no longer greatly influence tariff policy, the same cannot be said of protection. In fact recent indications are that pressures from both the United States and Canada are building for increased trade barriers, a move which would entail a great backward leap along the road envisaged by GATT of non-discrimination and multilateral tariff reductions.

3.2.8 Reciprocity

Another important tariff consideration, at least from the point of view of those of us living north of the 49th parallel, is the long espoused idea of reciprocity with the United States. In the years following the loss of a preferential position in the British market, the colonies made repeated efforts to reach a reciprocity agreement with the United States. The negotiations were protracted and illustrate graphically the difficulties Canadians have often encountered in securing trade agreements with the United States. What was of vital importance to Canada was relatively much less important to the U.S. and it was difficult to stir up sufficient interest in reciprocity arrangements. The alternatives have not been protection versus unilateral reductions in the tariff but rather protection versus a policy aimed at the reciprocal reduction of trade barriers between Canada and the U.S.

The Elgin-Marcy Reciprocity Treaty of 1854 provided for

free interchange between the U.S. and the B.N.A. Colonies of a comprehensive list of national products. However, this Treaty was abrogated in 1866 by the United States mainly over ill-feelings generated by the Civil War, and attempts have been made to establish a trade arrangement along similar lines ever since.

As protected industries increased in importance in Canada, problems of adjustment posed by a large-scale trade agreement became increasingly serious. Reluctance grew on the part of Canadians to include much free trade in manufactured goods thereby making the proposal less attractive to the Americans. The protected manufacturing industries themselves constituted a powerful and continuing source of opposition to proposals for the mutual reduction of trade barriers. During the late 19th and early 20th centuries, unrestricted reciprocity was pushed by the Liberals (led by Cartwright and Laurier) but this was never put to the test of negotiations with the United States. When this question was raised in earnest as in 1891 and 1911, the proponents of reciprocity were defeated. Strangely enough the issue of foreign ownership was never raised. In fact the fear was expressed that precisely the opposite might transpire if the tariff was removed:

> "Branch plants were obviously a creation of the tariff and it was equally obvious that tariff reductions under reciprocity might lead to an American withdrawal back across the border."[16]

During the Depression of the early 1930's commercial relations between Canada and the U.S. were somewhat strained. Agreements signed in 1935 and 1938 were the first large scale commercial pacts between the two since the Reciprocity Treaty of 1854. Neither provided a significant departure from traditional commercial relations however, and a return was made to conditions as they prevailed before the Depression. In the postwar period, negotiations have been carried on under GATT provisions and Canada has continued to show a primary interest in improved access to the American market.[17] The two economies have in effect become ever more closely linked together through trade with one another and through the investment of American capital in Canada. By and large, Canada's policy has been to go along with the trend of economic history while maintaining a sensitive attitude about the American economic presence in Canada and about the maintenance of Canadian sovereignty in the face of American influences.[18]

3.2.9 Summary

Inferences on recent changes in the level of the tariff often are drawn from changes in the ratios of duty collected to total and dutiable imports. On closer analysis, it would appear that these ratios exaggerate the extent of the reduction in the protective effect of the Canadian tariff, in particular in the postwar period. As with the

tariff of most other countries, many of the Canadian rate changes resulting from tariff negotiations could be described as "squeezing the water out of a tariff". Nevertheless, the protective effect of the Canadian tariff has been whittled away somewhat by the price increases, negotiated rate reductions, and changes in customs administration of the war and postwar years. And price increases continue to reduce the ad valorem equivalent of specific rates.

The average level of the tariff today is less than that of 1939 and probably less than that of the late 1920's. Since the tariff of the late 1920's is generally thought to represent a slight decline from the decade prior to World War I, and the pre World War I tariff a decline over that of the post National Policy decades of the 19th century, it would not be wholly inaccurate to say that present tariff rates are generally somewhat lower than the historical level.

3.3 And Today

3.3.1 Canada's International Trade Position

In their effort to increase exports of highly fabricated products, the Canadian manufacturing industry has enjoyed the full support of the Federal Government's Department of Industry, Trade, and Commerce. Measures taken by the Canadian government include proposals in the early 1960's strongly advocating removals or reductions of tariffs on fully manufactured products on a multilateral basis among

the major trading nations of the world; substantial financial assistance particularly in the area of export financing; significant fiscal incentives to expand and improve production facilities and to increase exports of processed material and fabricated products; and vigorous trade promotional efforts.

Canada strongly supported the United States in what became known as the "Kennedy Round of Trade Negotiations". The key objectivesof Canada's trade policy in these negotiations were set forth by the then Minister of Finance in these terms:

> "The negotiations will be more concerned with manufactured products and we must keep clearly in mind that the expansion of efficient secondary industries is necessary to provide adequate employment opportunities for Canada's growing labour force. For this reason we shall be looking for those particular tariff reductions abroad which will open up new export markets for the products of our secondary industries. This will help them to achieve better economies of scale which are vital to the attainment of cost efficiency."[19]

Canada's world trade position today is unique. It is the only one of the advanced industrial states that does not have assured free access to a relatively large market. The United States and Japan have very large domestic markets while all industrialized countries of non-Communist Europe belong to either the EEC or EFTA. Australia's position and policy appear to disqualify it as an exporter of manufactures on any scale.

Canada's lack of free access is important precisely

because it now has the potential for large-scale export of processed and manufactured goods. Unfortunately our home-market base is thought by some to be not sufficient, both because there are many manufactured goods which Canada is well-equipped to supply efficiently and because the Canadian system of protection has encouraged the duplication of undersized and excessively diversified production facilities. Were there fewer firms supplying each product line, the need for access to external markets would not be so great. As it is, many industries require both lower Canadian tariffs to induce firms to specialize and lower foreign trade barriers to give them greater market potential.[20]

3.3.2 Structure of the Tariff

The present policy of deliberately protecting domestic industries in the absence of multilateral as opposed to unilateral tariff reductions by imposing customs duties on imports has its roots as we have seen in measures taken in the period from 1879 to 1887, adopted partly in response to a severe economic depression. In the words of the Rowell-Sirois commission which surveyed this development some 60 years later:

> "The protective system thus established during 1879-1887 although modified and refined, and from time to time changed in emphasis, has never since been basically altered. It was a drastic change in the conditions under which the economies of British North American

> colonies had grown up, and subsequently was a major factor affecting the development and structure of the transcontinental economy which Confederation had created. It became, in truth, a national policy."[21]

Today the Canadian customs tariff is a complicated instrument of policy which includes a great multiplicity of rates of duty. In effect it is a three-part tariff: one part consisting of the lowest British Preferential rates; one of the intermediate most-favoured-nation or GATT rates; and one of the highest or general rates, these last being of little importance.

The number of items subject to duty is increased still further by the provision of special rates for various categories of imports. The most important of these special rates are those which apply to end-use items (i.e. items which are imported for a special purpose thereby allowing them a lower rate of duty than is generally applicable to the import in question); those which apply to imports of "a class or kind not made in Canada"; those which are subject to drawbacks or remissions.

It is not possible to give an indication of the average amount of protection provided by the Canadian tariff but an impression of the order of magnitude may be supplied. Few products of any importance receive protection whose *ad valorem* equivalent is 40%, or more; and most items in the M.F.N. class are concentrated at a level of 22 1/2% *ad valorem* or below. Needless to say, the structure of the *ad valorem*

rates gives no indication of the amount of effective protection which domestic producers receive in any given market. This amount depends on whether any rates of duty are applicable to imports which domestic producers require; on the ratio of the cost of imports bought at world prices to domestic value added; and on rates which protect the output sold by the domestic producers.[22]

The corollary of the amount of protection afforded domestic producers by the Canadian tariff, the burden imposed by the tariff on Canadian consumers will be examined as part of the case for tariff reform in the following chapter.

3.3.3 Effective vs. Ineffective Tariffs

Tariffs are recognized as having a variety of economic effects, but we are interested primarily in their effect on the allocation of resources within a country. J. H. Dales defines an 'effective' tariff as one that directly affects resource allocation and an 'ineffective' tariff as one that does not. He notes that there are ineffective tariffs of various kinds: (1) a tariff that is exactly matched by an excise or sales tax on domestic production of the good in question; (2) a tariff on goods that are not domestically produced, which means in effect that the tariff is then just a tax on the consumption of a particular commodity having no direct effect on domestic resource allocation;

and (3) a tariff on a good produced so efficiently at home that even in the absence of the tariff, imports could not compete with domestic production so that the tariff then has no effect on prices, government revenues, or resource allocation.[23]

Consideration of this third type of ineffective tariff leads us to some interesting observations. If a domestic producer exports regularly and in significant volume, we can be sure that he is a low cost producer by international standards and that he has nothing to fear from import competition. Accordingly sustained exports of a good provide excellent proof that a domestic tariff on that good is ineffective. Since the United States during the first half of this century was a large exporter of a very wide range of manufactured goods, we can conclude that in general, tariff protection of manufacturing in the U.S. during this period did not exist or was ineffective. However, in view of the great reduction achieved in the costs of producing manufactured goods in Western Europe and Japan in recent years, many of these tariffs may now be effective.

It is easily seen that a given tariff may provide any degree of protection from zero to infinity at a point of time, and a degree of protection that may vary equally as much over time. Not only is it very difficult to measure the economic effects of a protective policy, it is also very difficult to find out if it has any effect at all. In-

effective tariffs do little harm to a country in as much as they do not affect the allocation of resources. The countries that suffer from protectionism are those countries where the tariffs are effective, that is, those countries where manufacturing costs are only moderately above world costs, and thus lie below world costs plus domestic tariff rates.

> "The countries suffer, in brief, because their tariffs really work."[24]

And in Canada's case, it seems likely that the National Policy has been effective, and probably strongly so, during most of the past 90 years.

3.3.4 Effects of the National Policy

In their study of the Canadian past, historians generally refer to the national policy in Canada as meaning the triumvirate of railway building, Western settlement, and manufacturing development. The term National Policy is reserved for the protective tariff policy introduced by Sir John A. Macdonald in 1879 and embodying many of the features of later Canadian tariffs.

Among academics, a serious difference of opinion persists to the present day about the efficiency of the National Policy. Historians are virtually unanimous in their view that the tariff was an invaluable instrument of nation building and that economic nationalism was necessary to

political independence and the creation of a national economy. The noted Canadian historian Donald Creighton felt that "(the tariff) was intimately and vitally related to the other national policies;"[25] while J. B. Brebner comments on the Policy in these terms:

> "...Canadians began systematically to adopt the only procedure by which they could (remain separate from the United States) that is, the imposition of quite high tariffs on manufactured goods."[26]

W. T. Easterbrook and H. G. Aitken stated that:

> "(The detailed programme of Canadian nation building) appeared slowly and in piecemeal fashion but by 1879... the parts of the comprehensive and more or less complete pattern had fallen into place: a transcontinental railway, protective tariffs, land settlement policy, the promotion of immigration."[27]

On the other hand, economists imply that by lowering the standard of living, the National Policy weakened the national base on which political independence must stand and on which continuing economic growth must be based. The boldest statement of the economist's position is carried in H. G. Johnson's The Canadian Quandary, a position to be further examined in the following chapter. Johnson expresses grave doubts that the

> "current level of protection contribute(s) enough to national independence to justify (the) reduction in the Canadian standard of living."[28]

Even the historians Brebner and T.H.S. Careless both hint at the inconsistency inherent in protectionism, namely, the attempt to build a wealthy nation by lowering the standard of living of its population. Thus Careless notes that: "A

protective tariff plainly meant that goods would cost more to buy in Canada."[29] Also inherent in the Policy was the regional inconsistency, one that was to lead to much regional discontent in later years. V.C. Fowke in particular interprets the National Policy as a programme designed by and for Central Canadians. The Policy is seen not as national at all but rather as a policy of Central Canadian imperialism.[30]

Despite the grandiose and eloquent statements made by the politicians at the time of the introduction of the National Policy, the historian's national stereotype of the Policy has been challenged by W. A. Mackintosh.

> "It is not suggested that these national decisions were taken by governments, or still less by electorates, in full consciousness of their implication, nor that the interrelations among them were fully appreciated. They were in large measure the outcome of conflicts of interests and, to some extent, of political expediency."[31]

Historically it need only be noted that manufacturing was developing in Canada well before the tariff of 1879.

> "The new protectionist policy intensified, broadly speaking, industrial trends already visible."[32]

Economic historians as yet are not fully identified with either point of view. Their most articulate spokesman on the tariff, J. H. Dales, has vehemently attacked it for its evil effects on the quality of Canadian life while nevertheless providing a rationale for it by arguing that it fulfilled its mercantilist (but misguided) goal of

creating a larger population and aggregate income in Canada. Dales comments:

> "...there seems to be a dangerous unanimity of opinion that Canada is a transparently artificial entity whose very existence has always depended on something called a national policy. Canada, in this view, is a denial of geography and a travesty of economics that stands as living proof of the primacy of politics in the affairs of men."[33]

While the National Policy in terms of its relevance is now a thing of the past, the protective tariff clearly lingers on and is far from irrelevant to the contemporary economy. Nevertheless it is a remnant from the past in the important sense that the Canadian government has been consistently committed to multilateral tariff reduction since the Second World War as part of a broader committment to multilateralism. Differences of opinion among Canadians seem largely to be with respect to the rate at which the tariff should be abolished, and the manner in which it should be abolished, that is, unilaterally, bilaterally, multilaterally, or selectively by industry. The vanguard of the abolitionists has been led by the economists, while Ottawa has preferred to let other countries set the pace toward multilateral free trade and has been intrigued by selective arrangements such as that with the automobile industry.

There are then no longer any strong advocates of tariff protection, outside of some Canadian manufacturing concerns striving to protect their interests. "Insofar as tariffs

are its content economic nationalism is hardly a viable creed."[34]

The Canadian tariff segregated the Canadian market and induced industrialization behind its wall to serve that market. Foreign firms previously exporting to Canada, now found it necessary to shift production to Canada. Specifically, Macdonald's protective tariff, the National Policy, induced a spurt in branch plants, particularly American-controlled subsidiaries, in Canada.

> "As economists have long recognized and historians long ignored, the roots of the branch-plant economic structure in North America must clearly be traced to the operations of the National Policy of tariff protection."[35]

Instead of creating a Canadian bourgeoisie capable of leading Canadian growth, it tended to create only an emasculated bourgeoisie satisfied to manage a branch-plant economy.

> "In sum, the tariff created Canadian industry, but not necessarily Canadian entrepreneurship, and hence not necessarily industry under Canadian ownership and control."[36]

And foreign firms, once attracted by the tariff, had a vested interest in its perpetuation, while their very presence inhibited the emergence of Canadian firms.

> "Possibly (the tariff) caused more American penetration than completely continentalist or free trade policies would have encouraged. From the perspective of the late 1960's, it now appears to have been a peculiarly self-defeating kind of economic nationalism."[37]

3.4 Summary and Conclusions

In the mid 19th century, the tariff was the major source of government revenue making it hard to distinguish the fiscal from the protective motives in tariff changes. Some historians regard the provincial duties of 1846 as embodying protective intent but the rise of Canadian protectionism came no later than 1859 at any rate. After Britain's repeal of the Corn Laws, the Colonial Office made strong efforts to induce Canada to follow but without success. Confederation however, did establish the principle of low tariffs for mainly revenue purposes.

The failure of strenuous efforts to achieve reciprocity with the United States in the years after Confederation, plus an economic depression, led to the National Policy of 1879 which distinctly established the policy of protection in Canada the same year Germany broke the free trade movement in Europe. In 1879 Canada promoted the revival of Imperial Preference by reinterpreting the meaning of the most-favoured-nation clause in commercial treaties. This laid the foundation for Canadian policy in the 1930's depression which was a compound of high protectionism and Imperial Preference.

To generalize, one can say that Canada, though a great trading nation throughout its existence, was never up to World War II a leader in promoting free trade in the world. On the contrary, Canada was as quick as any to adopt

protectionist policies in response to particular national difficulties. Canada's role in GATT since the Second World War has been somewhat different but it is difficult to say whether Canada's basic attitude on international trade and protection has changed.[38]

> "It is high time that some one should write the history of Canada since Confederation as a triumph for the forces of economic and political development over the policies of Macdonald and his successors."[39]

The pattern of Canadian commercial policy, tariff and non-tariff elements combined, is as complex as that of any country in the world. For the tariff alone there is a multiplicity of rates, thanks to the Commonwealth preferences, the "end-use" and "class or kind not made in Canada" distinctions, seasonal arrangements, drawbacks, and so on. Then there are the customs administration practices, including classification, valuation, and anti-dumping provisions. Finally there are customs administrative barriers, quantitative restrictions, domestic subsidies and price supports, government purchasing policies, and voluntary restraints arranged or encouraged by governments. Canada's particular pattern may be explained largely by the peculiar needs of a country of Canada's size, dependence upon trade, and location. This patchwork of policy has never been entirely satisfactory and could be tolerated only so long as it could be assumed that Canadian secondary industry required protection to survive, currently a rather doubtful assumption.

H. E. English gives succinct expression to the feelings of many Canadian economists today when he states:

> "It is the maintenance of trade barriers by a country with a open economy that is at the root of the complexity of the tariff structure, and...the coming of a time when all the economy is more generally competitive internationally should be welcomed as an opportunity to reduce or eliminate arrangements born of awkward compromise between traditional export industries and those that have long relied on protection."[40]

He goes on to say that,

> "The only really satisfactory solution to all these problems is a rather general reduction of tariffs."[41]

And this is the subject of the following chapter.

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CHAPTER IV

THE CASE FOR TARIFF REFORM

4.1 Introduction

In the first three chapters of this study, the history of free trade and the history of the tariff in Canada were dealt with in some detail. Up to this point, a general theme has been developing, the trend toward regionalization of world trade, and an attempt will now be made to relate Canada's external economic relations and trade problems to that theme. In Chapter V, this will lead to an argument for an attempt to negotiate a Canadian-American free trade area. In the meanwhile however, quite apart from the benefits that Canada would gain from exchanging her protective policies for a reciprocal free trade arrangement with the United States, there is a strong case for both reducing the general level of the Canadian tariff unilaterally and reforming it so as to rationalize whatever protection is thought to be necessary.

To argue this is to argue against continuing proposals in favour of increased protection in Canada. However, protection is nothing more than a system of taxing the public in order to subsidize the protected industries. The crux of the matter revolves around the question of how much this protection costs and whether or not the benefits, if indeed

there are any, are thought to be worth the price.

4.2 Effects of the Tariff

4.2.1 The Argument

The effects of tariffs are pervasive and far-reaching. They influence the allocation of resources among alternative uses in the economy; they influence the distribution of income; they affect the rate of economic growth, the competitiveness of business enterprise, and the level of employment. These effects in turn influence, and are in some degree themselves influenced by, social, political, and cultural institutions and practices.[1] There may well be agreement on this point, but there are sharp differences of opinion about the extent, the significance, and even the "direction" these and other effects of tariffs have on the life of the country.

There are a number of ways in which an analysis can be made of the effects of the tariff on the economy depending upon the questions which are considered relevant. The question of primary concern here is an estimate of the cost of the tariff being paid by Canadians, in both cash and economic terms. The estimate is made of course on the basis of specific assumptions. Component parts of the estimate are dependent in considerable measure upon the somewhat speculative estimate of the reactions of exporters in

other countries to the opportunities presented by an open market were the tariff reduced. While differences of opinion once again are bound to prevail, there would probably be general agreement that studies of this kind serve a useful purpose in establishing rough orders of magnitude, thus setting some limits to the quantitative imaginings used by those participating in the controversy over the tariff.

4.2.2 Effects of the Tariff

As a broad generalization, industry exists in Canada because the country's population, size, and wealth justify it and because Canadians possess the skill, the capital, and the technical knowledge to produce industrial products efficiently. While there is little concrete evidence either way, Johnson holds that the tariff makes a minor difference to the overall size of the Canadian industrial sector. But, there is little contention that, "the tariff makes a great difference to the efficiency of Canadian industry."[2] It does so by providing a protected monopolistic position in the Canadian market to resident producers using inefficient production practices enumerated by the Second Report of the Economic Council of Canada. They included excessive product variety and short production runs with the resulting necessity of using more capital per unit of labour than in the United States.[3] "It is usually argued that the need for these production practices makes the tariff

necessary to make industry profitable; but the truth is that the tariff makes these inefficient practices necessary by making them profitable."[4]

Dales and Smith among others have been quick to point out the dysfunctions of the tariff over the long run.[5] It is clear that as A. Smith phrases it, "...in the kind of world in which we live today, higher tariffs do not produce a basic solution either for such general problems as unemployment and lack of vigorous economic growth, or even for the future prosperity of individual industries."[6] Instead Canadian tariffs not only have the usual effect of diverting resources into industries which have higher costs than foreign suppliers but also ensure monopolistic or oligopolistic industry structure and control of the market. The situation sees a few firms of varied size producing for the Canadian market and selling at prices equal to or almost equal to the import price plus the Canadian tariff.[7] Here the tariff contributes to one of the following forms of resource misuse: (i) if all available efficiencies of scale are in effect, the firms are all enjoying excess profit through higher prices and lower output made possible by the tariff--in this situation the industry is in no way dependent upon protection; (ii) where some or all of them are able to operate with production units which are less than ideal, resources are being wastefully used.[8]

The consequences of tariff protection for the organ-

ization of a market differ according to whether in the market in question, the excess of domestic price over world price is greater or no greater than that of domestic cost over world cost. Two cases are possible: In case one, domestic producers use protection to raise prices above world prices by more than the amount of the excess of their domestic costs over world costs; in case two, higher domestic prices merely reflect higher domestic costs as they would have existed if protection obtained from the tariff were no greater than strictly necessary to cover their cost disadvantage. If, under case one, the situation is characterized by efficient production, supernormal profits will result. On the other hand, case one may permit inefficient production financed in effect by supernormal profits. Under case two, the consequence of the tariff is to create a domestic source of supply which would not exist without the tariff, or to increase the size of the domestic source of supply above the level which would have been attained without the tariff. In either case, the real cost of the output obtained from domestic industry is greater than if the same output was obtained through international trade.

In judging the Canadian experience, Stykolt finds that the tariff is in excess of the irreducible amount required to maintain in Canada the present volume of output turned out and distributed in the most efficient manner possible and without any redistribution of income in the

form of supernormal profits. That tariffs should exceed this irreducible minimum is easy to understand. This minimum is often difficult if not impossible to estimate since the tariff is established in advance of domestic production and it must be remembered that this minimum does not remain constant over time but fluctuates as unavoidable domestic costs change in relation to world costs. Under these conditions rates of duty are often set above the real minimum in order to accomodate unknown contingencies faced by the new industry, to make possible the development of a domestic industry on an impressive scale, and to provide adequate protection in the face of changing world market conditions.

Once set, tariffs are difficult to reduce. Instead there are strong pressures to increase them in order to safeguard existing facilities and employment created in their shelter. "Thus one is led to the view that the tariff so affects market organization as to increase the cash cost of the tariff above the irreducible minimum, for by its very presence it tends to create market structures which either redistribute income (i.e. in the form of supernormal profits) or inflate unnecessarily the real cost of production and distribution."[9]

Under the protected market made possible by the tariff, it has been shown how the existence of foreign, especially

American, ownership makes possible a structure of Canadian industry which involves the duplication of undersized production facilities and thereby an important misuse of resources. It is interesting to note that in the recent flurry of anti-American pronouncements, this particular phenomenon has been largely overlooked though it may in fact be one of the most undesirable features of American investment in Canada. It is important to emphasize that the structure of Canadian industry in this case has been largely dependent upon the Canadian tariff. Some economists have indicated the need for a shift in emphasis and Watkins admits that "...free traders have had too easy a time in this country recently," while going on to assert that "it is nevertheless true that a new national policy must centre on foreign ownership rather than the tariff."[10]

Watkins however, takes a different view elsewhere of priorities concerning Canadian market structure and foreign control as a result of the tariff. Noting that Canadian exports of manufactured goods have risen significantly in recent years while the level itself remains low, Watkins sees the cause in these terms:

> "This is more probably the result of high costs, at least in part associated with an inefficient industrial structure that has grown up and been able to persist because of the Canadian tariff. This suggests that the appropriate policy is to abolish the Canadian tariff rather than regulate foreign investors..."[11]

In dealing with the effects of protection in Canada,

another important question concerns the regional impact of the tariff. According to the Economic Council of Canada:

> "Of all the major instruments of national economic development, perhaps none has proved to be a more potent source of interregional tension than the system of protective tariffs and related commercial policy devices."[12]

Over the years the regional unevenness of the cost of the protective tariff has been regularly used to support arguments for producing an elaborate structure of regional and national transportation subsidies, special assistance to primary products in agriculture and fisheries, and mining, tax concessions of particular regional interest, and revenue equalization payments to the lower income provinces.

In estimating the cost of the tariff, something should be said about the way in which this cost is distributed among regions. It is a fact that the Western and Maritime provinces, with less than their share of protected industries, unquestionably were adversely affected by the tariff. In a study for the Royal Commission on Dominion-Provincial Relations, Dr. Mackintosh argues that, while other factors have played a more important role in the economic difficulties encountered in the Maritimes,

> "the protectionist policy encouraged the growth of the steel and coal industries but in communities dependent on the traditional export industries, it accentuated the difficult problems associated with a declining population...and with declining rates of local investment. It presumably restricted the revenues of provincial governments and increased the expenditures necessary to cope with the problems of declining industry and declining areas."[13]

In broad terms, it is possible to distinguish two major influences upon the various regions resulting from the imposition of a tariff on imported goods. One from the side of consumption, the other from the side of production. The first consists of the cash cost of the tariff. All Canadian consumers and producers share in the cash cost of the tariff to the extent that tariffs affect the price of the goods they buy. But the impediments that tariffs impose on access to some cheaper source of supply in adjacent areas of the United States tend to result in a somewhat larger cash cost in the Atlantic Region and the Western Provinces than in Central Canada. The second influence is termed the production effect of the tariff, which acts to depress levels of output per employed person in Canada. Recent studies indicate that this affect of the tariff in the U.S. and Canada may be very substantial. Indeed the economic costs to Canada may be substantially higher than the "cash cost" of the tariff. These economic costs may in fact constitute a very significant element in the large and persistent gap in production by levels and in the average levels of real standards of living between Canada and the U.S. and between particular regions within Canada.

4.2.3 Cash Cost of the Tariff

Some reference has already been made to the cash cost of the tariff as the price Canadians pay for a policy of

protectionism. If such a calculation could be made with any precision, it would certainly interest all to know just how high a price is being paid. While there are great statistical difficulties involved, adding to the factors to consider in interpreting the results, it is possible to estimate the cash cost of the tariff by adding up the extra amount buyers pay for the products of protected import-competing industries, be they consumers or producers.

It is essential to recognize the essential similarity of the two techniques of tariffs and subsidies. Insofar as a tariff encourages the replacement of imports by domestic production, it has an efect essentially similar to that of a subsidy to an import-competing domestic industry. In general, the Canadian government has shown a decided preference for tariffs over subsidies thereby rendering an estimate of this cost a fairly complicated process. Rather than simply referring to the Public Accounts, it is necessary to conduct an extensive statistical investigation.

Estimates can be made from two directions. From the expenditures side, a comparison is made between the amount spent on purchasing the products of protected industries and the amount which the same quantity of goods would have cost if Canadians had been able to purchase freely in foreign markets. From the production side, the cash cost of the tariff in a particular industry is the amount of extra money payment which accrues to and remains in

the industry. This can be estimated by first comparing prices and determining the amount which the industry receives for its final products over and above the amount it would have received at world prices. From this amount, a deduction is made for any duties paid on imported inputs whether imported directly or purchased from other protected industries.

In general estimates are made from the expenditures side for simplicity's sake due to inadequate information in interrelations among protected industries. J. H. Young in his report to the Royal Commission on Canada's Economic Prospects compiled a detailed estimate of the cash costs of the Canadian tariff based on the year 1954.[14] Since output was considerably lower in 1954 than in more recent years, the estimate is most probably considerably lower than a more up-to-date figure. Young's estimate was not a comprehensive one and relates only to the private sector of the economy while omitting government purchases. This is a serious omission since governments are not only heavy purchasers from protected industries, but also give preference to domestic producers.

Price comparisons were generally restricted to the U.S. and Canada for ease of availability of data. This factor together with those noted above tended to give the final estimate of the cash cost of the tariff a distinct downward bias. In doubtful cases, the judgements made all

tended to understate rather than overstate the cost, so that it is likely therefore that while the range probably includes the correct total for 1954, the true figure is close to the top of the interval.

TABLE 4.1

ESTIMATED CASH COST OF THE CANADIAN TARIFF IN 1954 BY CATEGORIES OF EXPENDITURE

		Millions of Dollars
(1)	Food	90-95
(2)	Tobacco products	30-35
(3)	Alcoholic beverages	9-11
(4)	Recreation and reading	10-12
(5)	Clothing, footwear and personal furnishings	95-110
(6)	Household furnishings and operations	95-110
(7)	Household electrical appliances, radios, T.V. sets	34-38
(8)	Personal care	13-14
(9)	Medical, dental, pharamceutical	27-30
(10)	Gasoline and oil	9-11
(11)	Automobiles	72-105
(12)	Construction	77-92
(13)	Machinery and equipment	100-150
Total		610-753

Source: Young, J.H., Canadian Commercial Policy, (Ottawa: Queen's Printer, 1958), p. 72.

As shown in Table 3.1, the cash cost of the Canadian tariff for the year 1954, omitting government expenditure and making no allowance for the effect of the tariff on distribution costs, amounts to \$0.6 billion to \$0.75 billion or about 3.5% to 4.5% of gross private expenditure net of indirect taxes. The inclusion of government expenditure and retail distribution effects would raise the estimate considerably and it is likely that a comprehensive estimate of this kind for the year 1956 would be of the order of \$1 billion.[15]

Other economists who have thought about the matter subsequently have concluded that Young's estimate of the cost of the tariff to Canadian living standards is far too low. This results from the fact that he estimated only the extra cost of producing goods in Canada as compared with the United States, and made no allowance for the reduction of Canadian earnings due to the need to use production methods less efficient than those that would be employed in producing for a larger market.[16]

From this discussion, the pervasiveness of the effect of the tariff on the Canada economy is easily discerned. The tariff is essentially a device for taxing the public and subsidizing the protected industries. The tax takes the form of making the consumer pay more for the goods he buys than he would have to pay on the world market. The subsidy takes the form of allowing protected industry to

charge more for its products than their world market value.

> "Further tariff protection will not preserve an efficient manufacturing industry for Canadian consumers...It will merely saddle us...with a private tax on manufactured products."[17]

When a comparison is made between the prices paid in Canada for the product of protected import-competing industries and the prices on the world market, the high cost of this tax-subsidy arrangement is apparent even though the estimates are only of use in showing the general order of magnitude of the quantities involved.

The question to be asked is whether the current level of protection contributes enough to national independence or to Canadian economic development to justify this substantial reduction in the Canadian standard of living.

4.2.4 Economic Cost of the Tariff

The analysis of the previous section was concerned with the direct effect of the Canadian tariff on the prices of protected goods and the estimates made referred to the cash cost of the tariff. We are now in a position to examine the relationship which exists between the cash cost and the economic cost of the Canadian tariff. In other words, is the reduction in real income resulting from the imposition of a tariff greater or less than the extra amount paid out by purchasers of protected goods which could be obtained at lower prices abroad?

In a full discussion of this question J. Viner concluded that, if any effect on the terms of trade can be ignored, either because a single country is involved or because the reduction in tariffs is reciprocal rather than unilateral, the cash cost can then be regarded as an approximate measure of the economic burden of the tariff. It was his feeling that there are no significant economic benefits which need to be taken into account when moving from the direct observable cash cost to the economic cost.[18]

There are other complicating factors however, which prove to be difficult to measure in quantitative terms. Two of these factors are technical in nature and the fact they work in opposite directions reduces their impact. The first deals with the general level of prices in the tariff-levying country. To the extent that the tariff is levied unilaterally it leads to consequential effects on the balance of payments, and through price and income changes, to a new and different equilibrium situation with a higher level of money prices within the tariff-levying country. As in the case of terms of trade however, this effect can be largely disregarded if the imposition or retention of trade barriers by other countries is related to the imposition or retention of barriers in the tariff-levying country, thus furnishing another factor operating in the opposite direction.

A crucial issue surrounding the Canadian tariff is the effect it has had on the trade barriers facing Canada's

exports. In effect, Canadian economic development is under the influence of two sets of restrictions on trade, those imposed by Canada and those imposed by other countries. By no means are these independent of one another. It is almost inconceivable that the Canadian tariff would ever be reduced by any great margin without a very substantial reduction in American restrictions on Canadian exports and possibly reductions in restrictions imposed by other countries. The problem lies in estimating the total economic effect of the Canadian tariff when full account is taken of both the direct impact on the Canadian economy and the indirect effect through repercussions on the commercial policies of other countries.

We are concerned in particular with the possible effect of the Canadian tariff on those of the United States. If, in fact, the desire to maintain the Canadian tariff has had a strategic influence at critical turning points in U.S.-Canadian trade relations, then the economic cost of such a policy is heavy indeed. If the maintenance of the Canadian tariff has had an appreciable influence on the barriers imposed by other countries on Canadian exports, the cash cost estimate by neglecting this unseen half of the double burden therefore represents a substantial underestimate of the total direct and indirect economic cost of the tariff.[18a]

However, the reciprocal reduction of trade barriers while tending to neutralize some of the adverse effects of a unilateral removal, also confers a double benefit. It not only increases imports and through the mechanism of the system generates an increase in exports, but it also independently increases the opportunities for exports by reducing the trade barriers of foreign buyers. The economic cost to Canada of the trade barriers of other countries, particularly those of the United States, cannot be measured by the techniques used in this chapter (i.e., the cash cost of the Canadian tariff) but will be further investigated in the following chapter when the implications of a free trade arrangement with the United States are discussed.

4.3 The Scientific Tariff

Listening to official government statements on the subject, one would readily be led to believe that Canadian tariff policy is only part of an integrated and rational commercial policy. Is the Canadian tariff in fact a coordinated whole or is it little more than a haphazard collection of rates, established over a period of years in response to a variety of pressures? Indeed is there such a thing as a rational, consistent tariff structure which could be used in evaluating the existing structure of the Canadian tariff?

The best-known proposal of this kind has been termed the "scientific tariff" and calls upon tariff-makers to establish rates which will equalize domestic and foreign costs of production. Following this line of reasoning, the C.M.A. declares that "efficient Canadian manufacturers should always have an opportunity to sell in the domestic market on a fair competitive basis with imported goods."[19] In addition the Canadian Tariff Board Act requires that the Board shall, at the request of the Minister, make enquiry as to "the cost of efficient production in Canada and elsewhere, and what increases or decreases in rates of duty are required to equalize differences in the cost of efficient production."

In practice this principle has been of little or no help in establishing a tariff structure. As might be expected, the Canadian tariff, like the tariffs of all other countries, is not wholly logical or consistent, but has grown up in response to various economic, political, and other factors. While a "correct" set of rates may be extremely difficult to define, cost, in cash or economic terms is always a factor, and unless tariff-makers are given some information on the cost which will be acceptable, they are not in a position to establish a unique set of rates. The C.M.A. once again calls for an "...adequate Customs Tariff structure (to) be established, which is fair, just, reasonable, balanced, impartial, and in the national

interest."[20] Unfortunately, this eloquent statement is but little help in establishing the structure of the Canadian tariff or in setting Canadian commercial policy. Of course, many economists think that the only tariff which is in the "national interest" is no tariff at all! It has been shown that for the construction of an internally consistent tariff, two conditions must be met: (1) there must be a clear-cut objective or set of consistent objectives of a kind which can in fact be achieved by a tariff; and (2) there must also be a maximum price which the country is prepared to incur in achieving the objective or set of objectives. The simplest and most straight-forward aim would be to obtain the maximum possible amount of import-replacing production permitted under the given cost limitations.

There is little doubt that a schedule of rates based on the highly simplified assumptions of a maximum encouragement to import-replacing production at no higher cost than at present would call for substantial reductions in some rates, and substantial increases in others. Obstacles to a rational consistent tariff include the fact that it receives little attention from economists; more concern is shown over reducing the tariff structure rather than reconstructing it; and there are grave doubts that anything as highly political as the tariff could even be ordered on the basis of a set of principles. Any future attempt to make a

thoroughgoing revision of the structure of the tariff (the first since 1907) is bound to run up against these rigidities.[21]

Whether the arguments for protection as preserving our national independence are valid or not, the structure of the Canadian tariff is extremely difficult to justify in terms of any sort of national objective. In addition to the case for reducing the general level of the tariff, there is a strong case for reforming the structure of the tariff. The emphasis needs to be placed on the question of whether or not the purpose served by a particular tariff rate justifies the cost it imposes on the Canadian consumer.

4.4 Tariff Reduction

4.4.1 Introduction

The analysis of the economic cost of the tariff is, in effect, devoted to the question of how much higher Canadian income would be if the Canadian tariff had never existed or had been removed at some time in the past. A question of more immediate concern is how large an economic gain could be anticipated if the tariff were to be removed or substantially reduced at present? In drawing any conclusion whatever, adjustment problems and short-and long-run redistributive effects of a change in long-standing arrangements

must necessarily be taken into account. And of course a good deal depends on whether the reduction is unilateral or reciprocal, or whether it comprises a multilateral or a regional approach.

4.4.2 Repercussions

It is evident that the case for tariff reform is based primarily on the economic gain which might be expected to result from such a move. However, a policy change of such magnitude would not be without unavoidable repercussions. It can be said with certainty that the short-run economic gain to be anticipated from the unilateral removal of the Canadian tariff would be less than the cash gain. In fact the unilateral removal of the tariff might even result in a short-term economic loss.

A removal of the tariff would lead immediately to a fall in the price of protected commodities and thus to the disappearance of the cash cost of the tariff. The economic gain from the change however, might only be realized over a longer period.

Initially, the gain to purchasers of protected commodities would be offset by a loss to protected producers. But as factors of production in the protected industries shifted to other activities, or were reorganized within existing industries, the economic gain would gradually be realized. If the removal of the tariff and the resultant

fall in prices of protected goods were accompanied by a parallel fall in the prices of the factors of production employed in the protected industries, the initial impact would merely consist of a transfer of income from factors in the protected industries to purchasers of protected goods. No loss of output to the economy as a whole would result and as soon as the factors of production in protected industries shifted to more rewarding employment elsewhere in the economy, the output of the economy as a whole would rise.

It is quite possible however, that the adjustment of the prices of the factors of production would not take place with sufficient rapidity thereby causing some temporary unemployment of resources. If this occurred on a significant scale, a temporary fall rather than a rise in real income might accompany a major change in the tariff.

Adjustment problems would arise even if the reduction in the Canadian tariff were accompanied by a reciprocal reduction in the tariffs of Canada's major trading partners. But most important, given a reasonable measure of economic flexibility, in the long-run these adjustment problems would be overcome and an economic gain realized. The severity of the repercussions would be minimized, and the size of the economic gains maximized if reductions were organized under a reciprocal rather than a unilateral arrangement, or if staged reductions took place determined firmly in advance.[22]

Once tariffs are established however, businessmen

invest in fixed capital and employees develop particular skills in the expectation of the tariff's continued protection. Thus while it may be recognized that the continued existence of the tariff leads to an annual economic cost, this may not be a cost which can readily be eliminated in the short-term. Moreover, the process is certain to be damaging to at least some following the reallocation of resources. As such, it is not sufficient today simply to rehearse the classical arguments for free trade. It is necessary to recognize the functions the tariff performs and to substitute more efficient methods of performing these functions.

The tariff is originally used to encourage investment in particular lines of production, and once established, investment is undertaken in the expectation of profits guaranteed by the tariff. The removal of said protection should logically be accompanied by compensation to the industries concerned for the loss of their profit opportunities. The tariff has become an instrument for cushioning the impact of adverse economic changes on particular industries and regions. Adjustment assistance is a positive and constructive solution to the problems of helping industries adversely affected by foreign competition far more so than tariff increases. Failing alternative methods of assistance, there will inevitably be demands for continued and increased tariff support.[23]

In the meanwhile, it is necessary to remember that

while a tariff reduction would provide some incentive to rationalize Canadian industry, indeed in some cases at the risk of otherwise perishing, it does not in itself provide the means, be it capital, entrepreneurship, or planning, necessary for rationalization. And to argue that lowering the Canadian tariff would increase competition in Canada via increased imports is to partially ignore the extent to which the importers would be affiliates of Canadian firms whose pricing decisions are not predictable from assumptions of perfect competition.[24]

However, in a young, adaptable, and mobile economy such as we have in Canada, where resources are close to being fully employed, any losses in the short-run due to substantial tariff reductions will be offset by significant gains in the long-run.

In the past, the tariff has given at least marginal encouragement to American direct investment in Canada leading to political apprehension on the part of Canadians about American control of Canadian industry. In contrast, free trade would compel Canadian industry to rationalize in the face of outside competition, leading to more emphasis on domestic technology and design (the absence of which is often, and properly, deplored) thereby increasing the self-respect and feelings of national independence of Canadians.[25] Regionally, under free trade, the consumption effect of the national tariff suggests important relative

gains in real income for the Atlantic, Prairie, and Pacific Coast regions, little change in Quebec, and some relative decline in Ontario.[26] Monopoly would be avoided by international competition and goods and services which we are unable to efficiently produce domestically would be imported. In other words, the efficiency of the Canadian economy would increase tremendously as imports and exports would be determined primarily by comparative advantage. Even looking beyond the question of nationalism and economic self-interest, would not freer trade be a meaningful manifestation of more responsible international behaviour?

It follows from all this that:

> "...the appropriate policy for the Canadian economy is eventual free trade, which would be most efficaciously achieved...through the negotiation of multilateral tariff reduction."[27]

4.4.3 Multilateral vs. Regional Reductions

Two alternatives facing Canada with regard to the tariff question are the multilateral versus the regional approach. If we disregard for the moment the question of protectionism, Canada is left with the choice of whether or not to cooperate in an American initiative towards the elimination of tariffs on industrial products among the advanced nations and a general lowering of trade barriers. This move would naturally involve closer economic integration with the United States in particular plus the re-

duction or elimination of the tariff protection Canadian manufacturers presently enjoy against European and Japanese competition.

Multilateral tariff reduction through GATT involves considerably greater risks than regional trade liberalization. In the regional approach, participation is confined to countries of comparable levels of development and similar systems of economic organization making cooperation easier whereas the multilateral approach puts countries of different stages of development and very different systems of economic organization into close competition with each other. But despite the greater risks of unfamiliar competitors and unpredictable market conditions, multilateralism would ultimately entail greater advantages for Canada than would a regional free trade area with the U.S. alone.

Any regional or free trade area scheme necessarily involves discrimination against non-participants, discrimination which imposes an economic cost on the members by forcing their citizens to buy some products produced within the region at a higher cost than the international market price. Even in a regional arrangement with the United States, there would be some loss to Canada which would not exist if barriers to trade were lowered on a multilateral basis.

Indications are that the future will entail frequent and rapid changes both in the location of the most rapidly expanding markets and the relative competitive positions of

particular industries. Comparative advantage will be paramount. The maximum incentives to flexibility and quick response to changing conditions, and the maximum rewards for these qualities, are provided by free competition in a world market. Tariff protection reduces the incentives to flexibility and efficiency in the economy employing it and reduces the rewards of efficiency to industries in other economies that confront it.[28] As Dales says, "The tariff makes it impossible to tell which of your industries are efficient and which are not."[29]

Rather than retreat into traditional policies of tariff protection and reliance on the British connections as an offset to American influence, Canada must rethink her commercial and tariff policies, and adapt them to present trends of world trade and regionalization.

4.4.4 Reciprocal vs. Unilateral Reductions

In considering a large-scale reduction of the Canadian tariff it is clearly a matter of crucial importance whether the reduction is unilateral or is accompanied by the reduction of the trade barriers of other countries, particularly the United States. It is of course true that all countries prefer to make reciprocal rather than unilateral reductions in their tariffs, not only because the long-run benefits are greater, but also because the stimulus to export sales helps to offset any depressing effect the tariff reductions

have on import-competing industries. In addition, the reciprocal approach softens any adverse effect which the tariff reductions may have had on the terms of trade of the reducing country.

In the case of Canada, yet another reason why reciprocal reductions, particularly those involving the United States, are much more advantageous than unilateral reductions arises from the effect of Canadian and American tariffs on the Canadian industrial structure. In general, American tariffs, both in terms of rates and customs administration, haveprovided more favourable treatment for Canadian primary commodities than for manufactured goods. This differential tariff treatment, to the extent to which it has affected the Canadian economy, has tended to influence Canada's industrial structure away from secondary manufacturing and toward extractive and primary processing industries. The Canadian tariff, on the other hand, has been used to give the opposite effect. Thus in view of the fact that the two tariffs have had offsetting effects on the structure of the Canadian economy, it is possible that the extent of inter-industry shifts might be more limited under a reciprocal rather than a unilateral reduction.[30]

In view of the foregoing, it is perhaps not surprising that historically it is only reciprocal reductions which have had any appeal. "Canada's government...is unlikely to be able and willing to effect significant commercial policy

changes unless its chief trading partners have shown willingness to participate."[31]

4.5 Conclusion

The cost of the existing level of protection in Canada appears to be high, whether one measures it from the direct cash cost point of view, or from the indirect economic cost angle. In the light of its effect in reducing the Canadian standard of living, careful re-examination of Canadian commercial policy should be undertaken to determine if this high cost of the tariff confers any substantial economic or political benefits on Canada.

Canada can very easily be an efficient and prosperous trader in the world economy. To play this role effectively however, requires the abandonment of the effort to create a varied industrial structure by protection, and the adoption of policies aimed at concentrating Canadian effort on the specialized lines of production in which Canada has a definite comparative advantage. These policies would involve dismantiling the tariff and replacing it by policies designed to increase the efficiency and the flexibility of the Canadian economy.

> "If Canada has industries which could actually benefit from rationalization consequent upon tariff reduction, she has very little to lose from negotiations involving at least a measure of reciprocity in manufactured products, and much to gain."[32]

These changes would be desirable regardless of what

other nations did, but if in return for them Canada could obtain a reduction in the barriers to trade imposed by other nations, the economic benefits would be that much greater.

4.6 Footnotes

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CHAPTER V

FREE TRADE BETWEEN CANADA AND THE UNITED STATES

5.1 Introduction

The United States has historically always been a protectionist country; and Canada historically has employed the tariff as a tool for maintaining some economic separation from the United States, and specifically for promoting the development of a Canadian manufacturing sector. Nevertheless, the long-run historical trend has been towards increased interdependence of the two economies--economic integration in a broad sense--the forces of continental geography and the rapid growth of the United States triumphing over the intentions of the tariff policy, these forces being temporarily accentuated in recent times by the isolating effects of the war and Europe's postwar economic difficulties.

In past chapters, the trend towards regionalization of world trade was discussed as exemplified by the European Economic Community. In Canada, this trend appears as a tendency towards closer economic relations with the United States. This interdependence between the two economies has been described by some as a movement towards regional integration comparable to the formation of the E.E.C., but the "integration" in question, far from intro-

ducing economic efficiencies along the lines of the Common Market, has been warped by the tariffs of the two countries into a form involving serious economic inefficiencies and wastes of economic potential, especially from the Canadian point of view.

This trend suggests the advisability, on the grounds of economic defense and bargaining power in trade negotiations, of a Canadian move towards even closer economic relations with our neighbour to the south, and accordingly, Canadian policy should aim at some form of economic integration of the two. In this chapter an examination will be made of the case for a free trade arrangement between the United States and Canada. "The idea of a Canada-U.S. free trade arrangement is not new. Its history goes back more than a century."[1] Included will be a discussion of the possible political and economic consequences for Canada of such an arrangement as well as some speculation on third country effects.

5.2 Canadian-American Economic Integration

5.2.1 The Historical Trend

In terms of the past history and evolution of the Canadian nation, anxieties about Canadian dependence on the United States are certainly understandable. But one is made to wonder whether or not they are appropriate either

to the present stage of the Canadian economy and political development or to the present and emerging position of Canada in the world at large. Canada is becoming increasingly an integral part of North America, economically and culturally, if not politically. Elsewhere one notes a world evolution towards regionalism, with political and economic organization on a continental rather than a national scale.

The trend towards regionalization of world trade together with other developments of a protective nature do little for the prospect of negotiating substantial reductions in trade barriers through GATT along multilateral and non-discriminatory lines. In North America this is manifested as the development of closer trade and investment relations between Canada and the United States. It is precisely this growing economic integration with the U.S. that poses the chief dilemma of Canadian trade policy. Exports to the U.S. helped Canada to a post-war boom in economic growth with imports of American manufactures, capital, and technique providing many of the required resources. This period saw a basic shift in Canadian trade towards the U.S. as a market for exports, a supplier of imports, and a supplier of equity capital for Canadian manufacturing and resource industries.

In concrete terms, Canada's choice lies between resisting the trend towards closer economic integration with

the United States, and making a definite move to confirm and accelerate it. Economically, the arguments for integration with the U.S. are overwhelming; politically, the arguments opposing this integration may prove to be equally overwhelming.

5.2.2 Canada's Trade Position

For historical and political reasons, the North American economy is partially split by the 49th parallel. Despite the tariff and other conscious attempts such as the Commonwealth Preference system to divert Canadian trade elsewhere, the bulk of Canadian trade is still with the United States. Some 69% of Canada's imports and 55% of her exports are traded with the United States. (Table 5.1 and 5.2) Given the differences in the size of the two economies, this trade is of far less relative importance to the larger American economy. In fact, it accounted for about 20% of American total trade in 1963.

Canada's second largest trading partner by a substantial margin would appear to be the United Kingdom although more recent figures may reveal that Japan has expanded her Canadian trade ties sufficiently to surpass Britain. This trade exceeds that between Canada and all countries in European Economic Community combined but is still small in comparison with Canada's trade with her giant southern neighbour. And of course without the

TABLE 5.1

PERCENTAGES OF CANADA'S MERCHANDISE IMPORTS FROM VARIOUS COUNTRIES AND REGIONS SELECTED YEARS

(percentage based on current dollars)

Country or Region	1929	1937	1950	1954-56	1963-65	1963-65 Imports as % of 1954-56 Imports
	(1)	(2)	(3)	(4)	(5)	(6)
United States	68.8	60.6	67.1	72.9	69.0	153
European Free Trade Association	16.3	19.08	13.52	9.8	9.5	150
United Kingdom	15.3	18.20	12.70	8.8	7.6	138
Austria	0.05	0.05	0.03	0.1	0.1	321
Denmark	0.01	0.02	0.04	0.1	0.2	354
Norway	0.07	0.10	0.04	0.1	0.4	1039
Portugal	0.05	0.04	0.05	-	0.1	429
Sweden	0.17	0.27	0.16	0.3	0.6	331
Switzerland	0.62	0.4	0.5	0.4	0.5	186
European Economic Community	5.8	4.1	2.1	3.4	5.6	251
Belgium-Luxembourg	1.0	1.0	0.7	0.7	0.8	167
France	1.9	0.8	0.5	0.5	1.0	280
Germany	1.7	1.5	0.3	1.3	2.3	277
Italy	0.4	0.4	0.3	0.4	0.9	347
Netherlands	0.8	0.4	0.3	0.5	0.6	198

TABLE 5.1 (CONTINUED)

Country or Region	1929	1937	1950	1954-56	1963-65	1963-65 Imports as % of 1954-56 Imports
	(1)	(2)	(3)	(4)	(5)	(6)
Other Western Europe	0.02	0.01	0.0	0.2	0.3	304
Other	9.1	16.3	17.4	13.8	15.5	205
Eastern Europe	0.3	0.5	0.2	0.1	0.4	478
Middle East	0.1	0.2	1.0	0.7	1.3	283
Africa	0.3	1.9	1.1	0.7	1.2	275
Japan	1.0	0.7	0.4	0.8	2.4	458
Other Asia	1.6	4.8	4.2	1.8	1.9	259
Oceania	1.7	2.8	1.8	0.9	1.0	186
South America	2.3	3.1	5.5	5.9	4.9	133
Central America	1.8	2.3	3.2	2.9	2.4	138
Total	100.0	100.0	100.0	100.0	100.0	161

Source: Wilkinson, B.W., Canada's International Trade: An Analysis of Recent Trends and Patterns, (Private Planning Association of Canada, 1968), p. 30.

TABLE 5.2

CANADA'S MERCHANSIDE EXPORTS DISTRIBUTED
ACCORDING TO COUNTRIES
SELECTED YEARS
(percentages based on current dollars)

Country or Region	1928	1954-56	1963-65
	(1)	(2)	(3)
United States	39.6	59.5	55.0
European Free Trade Association	37.4	19.5	16.4
Austria	1.7	0.1	0.1
Denmark	0.5	0.1	0.1
Norway	0.6	1.1	1.0
Portugal	0.1	0.1	0.1
Sweden	0.4	0.1	0.3
Switzerland	0.04	0.7	0.4
United Kingdom	34.0	17.3	14.4
European Economic Community	10.5	6.6	7.1
Belgium-Luxembourg	1.7	1.3	1.3
France	0.8	1.0	1.0
Germany (West)	3.5	2.5	2.4
Italy	1.6	0.7	1.0
Netherlands	2.9	1.1	1.4
Other Western Europe	0.8	0.5	0.8
Other	11.7	14.0	20.7
Eastern Europe		0.7	4.3
Middle East		0.4	0.4
Africa	1.2	1.7	1.3
Japan	2.7	2.4	4.0
Other Asia	2.7	1.8	3.4
Oceania (Australia, N.Z.)	2.2	1.6	2.1
South America	2.3	2.5	2.3
Central America	0.6	2.9	2.9
Total	100.0	100.0	100.0

Source: *Ibid.*, p. 40.

Commonwealth Preference, this connection would be even less important.

However, the figures clearly reveal that in the last decade, Canadian dependence upon both the United States and the United Kingdom as a source of imports and a buyer of exports has declined somewhat. From Table 5.1, it is evident that increased trade with the industrialized nations of Western Europe has compensated for a large portion of the relative decline in Canadian trade with the U.S. and the U.K. On the other hand, Table 5.2 shows that no similar compensating rise in trade with Europe has occurred with exports. Those areas which have become more important on a relative basis for Canada's shipments abroad are Japan, Russia, and the less developed nations of Eastern Europe and Asia.[2]

Another view of Canada's trade position is provided in Table 5.3. The striking characteristic of this table is the imbalance in Canada's trade in each product grouping, a deficit of $2 billion in manufactured goods offset by an even greater surplus in food and industrial materials. This pattern holds true for Canadian trade with most areas of the world, especially the United States. The exception is Canada's trade balance with the less developed countries where the pattern is reversed.

As Wilkinson makes clear, manufactured goods are still a much larger percentage of imports (81.6%) than they are of exports (64.0%). Moreover, manufactures show an upward trend

TABLE 5.3

STRUCTURE OF CANADIAN TRADE (MILLION $)

	Food, beverages and tobacco		Industrial materials		Manufactured goods		Commodity totals	
	Exports to	Imports from	Exports to	Imports from	Exports to	Imports from	Exports to	Imports from
United States	347	332	1,497	377	1,453	3,153	3,613	3,990
European Economic Community	161	26	170	10	118	276	450	313
United Kingdom	274	30	469	41	197	410	940	483
Continental EFTA	24	9	79	20	29	80	133	109
Japan	96	7	156	2	18	112	277	121
Other developed countries	47	77	68	21	124	16	240	114
Less developed countries	141	224	108	127	259	61	507	782
Soviet-type economies	261	3	14	2	2	18	277	23
Total	1,351	708	2,560	600	2,199	4,126	6,436	5,935

Source: Wonnacott, R.J., "Trade Arrangements Among Industrial Countries: Effects on Canada", Balassa, B. (Ed.), Studies in Trade Liberalization, (Baltimore: John Hopkins Press, 1967), p. 52.

as a proportion of imports but a downward trend as a proportion of exports as evidenced in Table 5.4. Of even greater importance is the wide gap in the share of end products in total imports and exports, 54.3% and 17.4% respectively.[3]

Another economist, M. Watkins takes issue however, with what he terms the "Great Canadian Cliche" that Canadians are basically "hewers of wood and drawers of water":

> "It so happens that, while the Canadian economy relies heavily on primary production and export, the primary industries are technologically advanced and coexist with a large and diversified industrial complex."[4]

Nevertheless, this disparity is certainly large enough to imply that Canada may have considerable difficulty in maintaining the necessary surplus on merchandise account to offset a growing deficit in the non-merchandise account. This fact is bound to be of considerable importance in the negotiation of any significant trade agreements between Canada and her major trading partners. Of course the key question in any Canadian move towards free trade, either bilaterally with the United States or multilaterally under GATT, is what would be the impact on the Canadian economy of the inevitable further integration with the American economy. Two other related questions of similar importance concern the loss of Commonwealth Preference and the opening of western European (i.e. EFTA and the EEC) markets.

As part of a review of Canada's import and export patterns, it would be useful to discuss the Canadian position

TABLE 5.4

CANADA'S IMPORTS AND EXPORTS, BY STAGES

OF FABRICATION

1954-56 AND 1963-65

(percentages based on current dollars)

Stages of Fabrication	Imports		Exports	
	1954-56 (1)	1963-65 (2)	1954-56 (3)	1963-65 (4)
Crude materials	20.9	18.3	31.5	36.1
Manufactured goods	79.1	81.6	67.4	64.0
Fabricated materials	29.2	27.3	56.8	46.6
End products	49.9	54.3	11.6	17.4
Total	100.0	100.0	100.0	100.0

Source: Wilkinson, B.W., op. cit., p. 44.

in world trade as a whole. Because of our interdependence with the United States where both exports and imports are less than 5% of gross domestic product, Canadians tend to exaggerate the extent of the openness of the Canadian economy. Comparative data on imports as a percentage of national income show Canada to be around the median, admittedly much more open than the U.S., but having about the same reliance on trade as Britain, Australia, and West Germany, and a lesser reliance than Norway, New Zealand, Sweden, Denmark, or the Netherlands. (Table 5.5)

In table 5.6, Canadian trade both as a percentage of world trade and of trade of industrial countries is shown to decline despite the increasing proportion of world trade being conducted by the industrialized nations of the world including Canada. Wilkinson indicates that in the last few years however, there has been an improvement in Canada's relative export performance; whether or not this is indicative of a long-term trend it is difficult to say.[5]

International comparison of the concentration of exports on a few commodities similarly runs counter to popular opinion in Canada. A recent study by B. Massell compares 36 countries in terms of export commodity concentration. Using two different measures, Massell ranks Canada 30th by one and 31st by the other, in terms of high to low concentration. In both cases, the United States ranked lower than Canada and Sweden higher.[6]

TABLE 5.5

MERCHANDISE IMPORTS AND EXPORTS AS PERCENTAGES
OF GROSS DOMESTIC PRODUCT
VARIOUS COUNTRIES, 1953 AND 1962-63

(percentages based on current U.S. dollars)

	Imports		Exports	
Country	1953	1962-63	1953	1962-63
Canada	16.8	15.8	16.4	17.0
United States	3.3	3.2	4.7	4.3
European Free Trade Association				
Austria	16.5	25.4	16.2	20.4
Denmark	23.7	30.6	21.6	25.7
Norway	25.4	31.7	14.2	18.6
Portugal	18.9	21.0	12.5	13.3
Sweden	18.7	23.6	17.5	22.2
Switzerland	20.6	28.9	21.0	21.3
United Kingdom	17.3	16.7	13.7	14.6
European Economic Community				
Belgium-Luxembourg	31.7	39.2	29.7	37.2
France	11.4	12.0	10.9	11.5
Germany (West)	11.2	16.2	13.1	17.9
Italy	10.2	16.0	6.4	11.4
Netherlands	29.0	40.9	26.3	34.5
Other				
Australia	13.0	14.0	19.9	15.1
New Zealand	19.9	19.0	24.3	19.6
Japan	12.8	11.4	6.8	9.5

Source: *Ibid.*, p. 14.

On the matter of geographical concentration of trade however, Canada ranks very high because of our very close trading links with the United States. Ranking the same 36 countries from high to low in geographic concentration, Massell placed Canada 6th and Sweden 31st, with New Zealand being the only developed country ranking higher.[7]

5.2.3 U.S.-Canadian Trade Barriers

The classic theoretical arguments for the reduction of trade barriers are well-known. Some review of the particular dysfunctions of the tariff walls imposed on each other by the United States and Canada is now in order. On the one hand, the American tariff structure, with low duties on raw materials and high duties on finished goods, has encouraged the establishment in the United States both of processing activities that could be more cheaply and economically performed in Canada, and of manufacturing of labour-intensive goods that could, given the wage differential between the two countries, be more cheaply supplied from Canada assuming equal productivity. In addition, American policy has in various ways impeded American access to Canadian resource products, the most recent example being the *de facto* import quotas on oil from Canada to the United States imposed by President Nixon.

On the other hand, the Canadian tariff has fostered the development of inefficient high-cost manufacturing of goods

FIGURE 5.6

CANADIAN TRADE AS A PERCENTAGE OF WORLD TRADE AND OF TRADE OF INDUSTRIAL COUNTRIES, ANNUALLY, 1953-65
(percentages based on current U.S. dollars)

Year	Canadian Trade as % of World Trade		Canadian Trade as % of Trade of Industrial Countries[a]	
	Exports (f.o.b.)	Imports (c.i.f.)	Exports (f.o.b.)	Imports (c.i.f.)
	(1)	(2)	(3)	(4)
1953	6.2	6.2	9.6	9.7
1954	5.8	5.6	8.9	8.9
1955	5.7	5.7	8.7	8.8
1956	5.7	6.3	8.4	9.5
1957	5.4	5.8	7.9	8.9
1958	5.7	5.6	8.3	8.7
1959	5.6	5.9	8.2	8.8
1960	5.2	5.2	7.4	7.8
1961	5.2	5.0	7.3	7.4
1962	5.0	4.9	7.1	7.1
1963	5.0	4.6	7.1	6.7
1964	5.3	4.7	7.5	6.8
1965	5.2	5.0	7.2	7.2

[a] United States, the United Kingdom, industrial Europe (i.e., the Common Market and European Free Trade Association countries except Portugal), Canada, and Japan

Source: Ibid., p. 17.

in Canada that could be obtained more cheaply from American suppliers. Both tariffs operate to reduce the standard of living of both countries; each reduces the standard of living of the country that imposes it by increasing the costs of the goods it consumes, and the standard of living of the other country by depriving it of profitable production opportunities. " As long as any tariff remains, valuation and other customs practices handicap the development of regular trade flows."[8]

The loss to Canada from the existence of the two tariffs on Canadian-American trade is relatively far greater than the loss to the United States. Thus the overall cost of protection to the Canadian economy is relatively higher than the cost to the American economy. The cost of Canadian protection has been estimated at about 4 1/2% of national income, the cost of American protection at about 2% as revealed in Chapter IV of this study. Moreover, the two tariffs have been in part responsible for the two features of Canadian-American integration that have most irritated Canadian nationalists in recent years: the American tariff by encouraging Canadian concentration on resource extraction and primary manufacturing, (i.e., the old cry about "hewers of wood and drawers of water") the Canadian tariff by encouraging the establishment of American manufacturing concerns in Canada and fostering American acquisition of control over Canadian enterprises. (i.e., the "branch-plant" economy). By encouraging

the establishment of American subsidiaries and creating a protected oligopolistic market for manufacturers, the Canadian tariff has also made necessary the inefficient production practices (i.e. full product ranges, and short production runs) that Canadian manufacturers including the representatives of American subsidiaries are wont to advance as arguments for sustained or increased tariff protection.[9]

This last subject has received considerable attention in recent literature on Canadian trade and some mention has been made already of the question of tariffs and economies of scale elsewhere in this study. On the one hand, it is claimed that there exist too many plants of less than optimum size operating in Canada, a position made possible by the Canadian tariff which provides domestic producers with a significant margin by which their prices may exceed those of the world market. This problem is compounded by the high degree of foreign ownership of Canadian industry, another fact together with the tariff which affects a firm's decision of whether to build a plant of less than minimum optimum size when his market share justifies it or to build a plant of minimum optimum scale.

The other half of the question asserts that while plants may be optimum scale as measured by size of investment, the protected market situation may induce them to produce too many product lines to achieve the length of product run necessary for true economies of scale of minimum

unit costs. The conditions leading to the aforementioned structure of Canadian industry are further intensified by the existence of foreign tariffs, expecially those of the United States which severely restrict Canada's export potential. Moreover, a number of recent studies have tended to support these views empirically.[10]

5.2.4 Economic Integration

One of the major components in the economic integration of Canada and the United States is the growing American investment in Canadian industry. The net use of foreign resources as a percentage of net capital formation in Canada between 1950-55 was 19%, and the corresponding figure for the period 1956-57 was 33%.[11] Most of this imported capital has come from the U.S. and has been a key factor in Canada's expansion since World War II.

However, much of this investment has tended to be concentrated in the resource and manufacturing industries in a few large firms which have a dominating influence over their respective markets. A good indication of the extent of this foreign ownership of the Canadian mining and manufacturing sector is given in Table 5.7.

Canada would appear to have more of its industry owned and controlled by foreigners than any other nation in the world. Such great external ownership may mean that many of the business decisions most important to the functioning of

TABLE 5.7

PERCENTAGE OF CANADIAN MANUFACTURING INDUSTRIES
OWNED BY FOREIGN-CONTROLLED FIRMS, 1963

Industry	Percentage of Industry Assets Held by Foreign Corporations: At Least 50% Non-Resident-Owned (1)	At Least 25% Non-Resident-Owned (2)
Primary processing	77.4	81.4
Primary metal	60.2	67.0
Petroleum and coal products	99.3	99.6
Other primary manufacturing	37.0	56.2
Food	31.2	36.4
Beverages	13.3	20.4
Tobacco	85.3	85.3
Leather	27.1	31.5
Wood	28.0	48.9
Paper	40.9	63.4
Non-metallic mineral products	51.1	54.0
Secondary manufacturing	61.7	67.7
Rubber	92.0	92.0
Metal fabricating	51.3	53.2
Machinery	63.7	64.6
Transport equipment	84.2	84.7
Electrical products	66.6	80.4
Chemical products	76.6	92.8
Miscellaneous products	64.6	65.6
Other	63.1	68.2
Total	56.5	67.0

Source: Ibid., p. 126.

the Canadian economy are made by non-Canadians. Such decisions in the past seem generally to have been made in the best interest of Canada, but there is no guarantee that such will always be the case. Moreover, this inflow of capital could leave Canada with a major balance of payments problem, should a recession in either country cause U.S. investors to lose confidence in Canadian enterprise.[12]

Regarding American ownership in Canadian firms, the main complaint above that decision-making by non-Canadians may produce different decisions than decision-making by Canadians rests, of course, on the doubtful assumption that Canadian businessmen always make decisions in the national interest. In any case, as Johnson reiterates:

> "If corporate operations raise questions of the public interest, the public interest is more appropriately safeguarded by its legislative guardian, Parliament, than by shareholders and directors qualified only by Canadian citizenship to judge the national interest."[13]

Foreign ownership and control in Canada has many possible implications for Canadian import and export trade, and this question has been fully treated by Safarian.[14] His statistical results indicate that for foreign-owned secondary manufacturing firms, imports as a proportion of total purchases were greater than or roughly comparable to domestic-owned firms. For exports however, Safarian's empirical tests show little statistically significant difference between the export performance of domestic and non-resident firms. These

results bear out his conclusion that foreign parents would be hard put to justify reserving world markets for themselves if in the long run, Canadian subsidiaries could produce and export more cheaply than they themselves.[15]

Beyond the issue of foreign ownership, a second source of Canadian vulnerability lies in the fact that the Canadian economy is partially dependent on foreign trade and most particularly on American-Canadian trade. Certainly there are risks involved in concentrating such a high percentage of foreign trade on a much larger trading partner. (tables 5.1, 5.2) Clearly changes in activity levels in the United States are of crucial interest to Canadians, as evidenced in the current battle, both north and south of the 49th parallel, against inflationary trends. The fear is expressed that the proximity of the United States and our mutual economic interdependence renders Canada susceptible to the transmission of business cycles from the south. However, in a study done for the Royal Commission on Canada's Economic Prospects, Bracher and Reisman found that downturns have been known to start in Canada prior to the U.S. and that Canadian depressions are typically less severe.[16]

Heavy reliance on trade with the U.S. is understandable for geographic reasons; it has raised the Canadian standard of living by providing markets for abundant Canadian resources and easy access to those goods in which Canada is an inefficient producer. But dislocations through sudden changes in

American trading policy and the possibility however remote of exploitation of smaller Canada by the larger United States are also matters of no little concern to Canadian policy-makers.

As the economic and political relations of Canada and the U.S. grow closer, what is the risk of sudden changes in American policy or the growth of protectionism in either country? How far removed from reality is the possibility of American economic exploitation to the detriment of Canadians? Indeed, to what extent is this presently the case? The two opposing viewpoints on this score give all appearances of being next to irreconcilable.

On the one hand, the prominent Canadian economist Melville Watkins recommends that:

> "The most sensible Canadian solution is to accept close trade ties with the United States as a tolerable fact of life and join with her in pressing for a multilateral reduction of tariffs that would open the markets of the world to Canadian exports."[17]

On the other hand, Knelman, a professor of humanities of science at Sir George Williams, speaks for many Canadians when he declares:

> "There is a clear and present danger that we might be selling out industrial potential for a mesh of pottage...What is at stake is the complete ownership and exploitation of Canada by the United States...Before it is too late we should resist the United States' committment to uncontrolled growth...We should do this out of principles not venal patriotism or misdirected resentment."[18]

This view is based primarily on the observation that

from a resource viewpoint, the United States is a have-not nation. Some 33 separate minerals and other basic materials are on a "critical" list. Among those the U.S. must now import and continue to do so on an accelerating scale are crude oil (30% imported), iron ore (40%), bauxite (95%), copper (75%), lead (50%), zinc (55%), potash (over 50%), uranium (over 50%), pulpwood, timber, chromite (95%), manganese (95%), rubber (95%) and gold (90%). It is inevitable that Canada, resource-rich but population poor, by virtue of its proximity to the resource-hungry but rich United States, will be the target of enormous pressures. As we have seen, U.S. corporations already largely control, among others, our petroleum, natural gas, paper, potash, nickel, and copper.

The issue of foreign ownership involves basic principles of national identity, purpose, and development. The confrontations of the future can be partially foreseen by glancing at a projection of American resource needs versus Canadian production (Table 5.8).

Many of these resources already constitute major Canadian exports to the U.S., not to mention the fact that many are already controlled by American corporations.

Beginning with the bargaining over our British Columbia water resources, a long and hard negotiation period was initiated over the so-called "continental energy plan". These actions include President Nixon's instructions to his state de-

TABLE 5.8

PROJECTED CANADIAN EXPORTS TO US
(Percentages represent portion of total Canadian production exported to US)

Resources	1970	%	1980	%	1990	%
Uranium	2,000 tons	50	4,900 tons	70	9,000 tons	90
Iron Ore	30,000,000 tons	80	60,000,000 tons	90	250,000,000 tons	95
Lead (all commodities)	25,000 tons	55	50,000 tons	70	100,000 tons	90
Mercury	5,000 76-lb. flasks	15	100,000 flasks	40	25,000 flasks	90
Copper	155,000 tons	33	300,000 tons	65	600,000 tons	95
Potash	3,000,000 tons	98	4,000,000 tons	--	6,000,000 tons	--
Zinc (all commodities)	160,000,000 tons	50	250,000,000 tons	70	400,000,000 tons	90
Gold	3,000,000 troy ounces	98	4,000,000 troy ounces	--	6,000,000 troy ounces	--
Petroleum	145,000,000 barrels	95	300,000,000 barrels	--	1 billion barrels	--
Natural gas	1.6 trillion cubic feet	98	3 trillion cubic feet	--	6 trillion cubic feet	--
Water		--	100 billion gallons	20	200 billion gallons	40

Source: Knelman, P., "Will Canada Become the 51st State?", Weekend Magazine, June 27, 1970, p. 11.

partment to examine with Canada a continental energy plan; Prime Minister Trudeau's move to prevent the sale of Denison Mines Limited to the United States' Continental Oil Company, thus preventing foreign control of 90% of Canada's uranium; President Nixon's naked power play in restricting oil imports from Canada "during the period of transition to an alternative U.S.-Canada energy policy"' the development of coastal sovereignty and Arctic jurisdiction, and Canada's strong stand on policing pollution in Arctic waters; and Energy Minister J. J. Greene's warning that a new set of rules of ownership is being developed for the Canadian economy.

The pattern of American investment, as clearly illustrated in the structure of their tariff policy, is for capital to flow to resources in less-developed, resource-rich, or population poor countries such as Australia, Canada, and South America. The consequences for the structure of Canadian industry have already been discussed.[19]

But while our growing dependence on the United States is interpreted by some as a threat to Canadian independence and national identity, any serious effort to reduce this dependence would come only at the bearing of high costs to all Canadians. Restrictions on the flow of investment capital in Canada would lower the rate of economic growth; diversion of Canadian trade from the U.S. to the other trading nations or groups such as the U.K., the Commonwealth, or Europe, would involve economic costs in the form of a reduced standard of

living and possible rate of growth; the same is true of a diversion from foreign to domestic trade by means of increased protection. A contrary policy of reducing the relative importance of trade with the U.S. through expanding trade with the rest of the world by multilateral reduction of trade barriers would encounter political opposition not only from abroad but from the vested interests in the Canadian tariff at home. This may entail a political cost rather than an economic one.[20]

In short, the conflict in Canada is one between national sentiment and national self-interest.

5.3 Implications of Alternative Proposals

5.3.1 To Choose or not to Choose

During the first half of the 20th century, several opportunities presented themselves for securing a substantial reduction in the American tariff on exports from Canada as a by-product of a reduction in the Canadian tariff. Indeed, this is the only way the issue of protection versus freer trade has ever arisen in Canada tariff history. Likewise, it may be predicted with some confidence that reciprocity is the only way it is likely to arise in the foreseeable future. It is hard to imagine the Canadian tariff being reduced unilaterally without an equally substantial reduction in American restrictions on Canadian exports and possible reductions in

trade barriers imposed by other countries.[21]

By and large, two assumptions have been paramount in Canada's making of commercial policy: (i) the wealth, the proximity, and the traditional economic ties of the United States and Canada will combine to place Canada in a position of favour vis-i-vis other nations in the U.S. capital market; and (ii) the growing economic interdependence of Canada and the United States will be counterbalanced within a general movement towards freer trade among western nations. Indications are, however, that both of these assumptions are rapidly losing their validity. Firstly, American capital has become a scarce commodity, and if Canada is to have a privileged position in the American capital market, it will have to associate itself more definitely with the U.S. against European countries whose balance-of-payments surpluses have been threatening the dollar. Secondly, the formation of the E.E.C. and E.F.T.A. are both indicative of the regionalization of world trade patterns. Thirdly, U.S. resource needs intensify the problem of the already heavily foreign-owned Canadian resource sector and point the way to hard and complex bargaining sessions between Canada and the U.S. over the continental energy plan, with little sacrifice of economic self-interest on eith side.

Canada's choice appears to lie between being pushed by increasing European tariff protection (plus a possible loss of British preference should Britain be successful in gaining

entry to the E.E.C.) into closer involvement with the United States, and deliberately seeking some form of economic integration with the U.S. consistent with Canada's views on political independence, as a means of strengthening Canada economically.[22]

5.3.2 Free Trade Areas vs. Customs Union

Of the many implications of the various forms of economic integration, perhaps that which receives the most attention is the political question. A point not often stressed is the fact that alternative trade proposals all have quite different political implications.

In seeking to reduce trade barriers between Canada and the United States, there are several apparent reasons why a free trade area is to be preferred rather than a customs union or a more comprehensive economic union involving the co-ordination of economic policies and planning. While a free trade area requires a customs check on the origin of goods made with imported components, and a customs union involves no such administrative problems, the free trade area allows much more freedom among members in their negotiations with other countries, a freedom some think essential to the maintenance of Canadian independence.

Under a customs union, there is a greater loss of autonomy for participating countries. The necessity of common tariff policy inevitably restricts each in this policy dimen-

sion, and given the relative size and bargaining power of the United States, Canadian loss of control over tariffs would greatly exceed that of the U.S. Canada would no longer be able to independently determine its level of trade with less developed countries, nor would it be able to participate in the Commonwealth Preference system. A customs union also implies the free movement of persons, capital and enterprise, and the coordination of fiscal and other policies. It should be noted, however, that most of the advantages of international mobility of factors of production are already available under existing Canadian-American economic arrangements, whereas the coordination of other policies can best be handled when required by intergovernmental negotiations of the type already customary.

On the contrary, a free trade area involves only the free movement of goods and of equal importance, is consistent with the rules of GATT with one important exception. Neither country would be agreeable to free trade, it is thought, in at least some of its agricultural products, that is, those subject to support-price policies and other agricultural subsidy and intervention programmes. Nevertheless, it seems likely that previous GATT decisions and the prospective acceptance of the EEC would allow special arrangements for agricultural products to be justified under the GATT rules. Under such an arrangement, Canadian vulnerability in one sense would be significantly reduced since for the first time Canada would

acquire from the U.S. a treaty committment not to raise tariffs against Canadian goods. Such a treaty obligation is a necessary condition for Canada on entering a free trade arrangement as the only guarantee that the restructuring of Canadian industry can take place under firm and stable long-run expectations.[23, 24]

5.3.3 Selected Free Trade

Not wanting to completely open both borders, some economists have arrived at the compromise solution of a "selective" approach towards free trade with the United States. Through this arrangement, Canada would offer free entry to certain selected American products in return for free entry of other selected Canadian products of the same industry to the U.S. market. The approach is not new and recent examples include the U.S.-Canadian auto agreement of 1965 and the European Coal and Steel Community just prior to the formation of the E.E.C. According to Johnson, however, "the mechanics of operating such a system presuppose a degree of intervention in the affairs of private industry inconsistent with the conception of free trade and unlikely to be acceptable on any scale to either country."[25]

5.3.4 Common Currency Area

Another suggestion relating to and aiming at the reduction of U.S. and Canadian trade barriers would have the

two countries join in the formation of a common currency area. This particular option would necessarily involve considerable loss of autonomy for both countries, with Canada bearing the brunt of the loss on a relative basis. The setting up of a single North American bank, or extremely close monetary coordination between the two central banks would be necessitated in order to manage a single currency. Canadian monetary authorities would be forced to operate under quite stringent limitations of freedom of action. And since monetary policy and debt management are so closely related, monetary coordination would severely restrict Canadian fiscal freedom (i.e. as in incurring budget deficits).[26] It might be expected then, that the formation of a common currency area would never reach the bargaining stage considering the number of political implications involved.

5.3.5 Atlantic Free Trade Area

"In purely economic terms, there is a strong Canadian case for initially undertaking free trade with the U.S. alone."[27] While third country benefits (to be discussed later in this chapter) would be foregone during the interim, there are nevertheless a number of special advantages in such a scheme. The primary Canadian advantage over the United States is in terms of lower wage costs. Consequently if a free trade area included other countries such as Japan and various European nations with even lower wages, they may

very well preempt many of the labour-intensive activities that might otherwise choose to locate in Canada.

It is also evident that rationalization would involve great elements of risk for Canada under an Atlantic Free Trade Area (AFTA). If only the United States and Canada are included in a North American Free Trade Area (NAFTA), the Canadian problems would involve adjustment to American cost levels which may fairly reasonably be regarded as fixed by Canadian producers. But if Europe and Japan are included many new dimensions of uncertainty are involved. It may also be argued that if only the U.S. is involved, Canada may be more likely to receive special treatment of the kind suggested by the Canadian-American Committee in their plan calling for U.S. tariff reductions of 20% per year, but Canadian reductions of only 10%.[28]

The critical question remains: what kind of commercial policy change is required? According to English:

> "While many processed goods can be exported to both America and overseas markets, it is the American market that offers by far the best opportunity for increased exports of manufactures, because of proximity and the similarity of consumption standards and production techniques."[29]

But while a Canada-United States free trade arrangement would be the most feasible initial step, a more general free trade arrangement would, for most Canadians, be the preferable ultimate objective.

5.3.6 Multilateral Tariff Reductions

With regard to tariff reductions under the most-favoured-nation principle, the issues are the same whether the comparison is between NAFTA and Canadian-American bilateral reductions, or between AFTA and multilateral reductions. In either case, partial tariff reductions under m.f.n. are the less satisfactory alternative from the Canadian point of view for the following reasons: (i) E.E.C. discrimination against Canadian exports would be completely preempted by AFTA (as would American discrimination under NAFTA) but would be only partially prevented by the limited tariff cuts that are likely to follow multilateral trade negotiations; (ii) partial tariff elimination would lead to only a partial reorganization of industry; and (iii) such an option would comprise a less efficient route to the ultimate goal of complete elimination of tariffs, than a NAFTA or AFTA treaty.

For Canadian industry, the major problem is one of reorganization and rationalization, the key being entry into the U.S. market. The question remains: on what terms? To facilitate long-run planning, and to eliminate being caught in a series of costly reorganizations rather than once-and-for-all converting their facilities, a treaty commitment to eventually eliminate tariffs keeps elements of uncertainty at a minimum. By contrast, a succession of bargaining rounds leaves the results of each round, as well as the end result,

in considerable doubt.

Any empirical projection of Canadian trade performance requires a key assumption about the extent of Canadian industry rationalization. Consequently, it would be extremely difficult to predict the degree of reorganization and cost reduction that would occur in Canada in the event of successive tariff reductions under m.f.n. Nor are there any clear indications for judging the impact on Canadian export and import trade. It is evident however, that any improvement in Canadian performance would be substantially less than that expected under the assumption of a fully rationalized Canadian industry, operating in a completely unrestricted free trade area.

Of course this is not to argue against current negotiations, but only to suggest on purely economic grounds, that another alternative would be preferable to rounds of tariff negotiations from the Canadian point of view. However, the establishment of either an Atlantic or a North American free trade area may not be feasible for some time to come, while the Kennedy Round has succeeded and others may follow. Furthermore, with regard to the political question, successive rounds of tariff reductions show clearly certain political advantages for Canada. For one, Canadian public opinion may be more easily united behind a gradual programme while politicians remain frightened by such a drastic change as complete free trade. Secondly, the

Commonwealth Preference system should be in relatively little danger, although the extent of the preferences seems sure to be reduced gradually in any case. And thirdly, the less-developed countries would stand to benefit more from tariff reductions under the m.f.n. clause in contrast to discrimination inherent in AFTA or NAFTA.[30]

5.3.7 Underlying Assumptions and Considerations

As mentioned earlier, various schemes aimed at achieving closer economic integration with the U.S. without damaging Canadian secondary industry, must rely heavily on the assumption that Canadian industry could compete in the American market if allowed free access to that market. In short, Canadian industry must demonstrate the ability to rationalize once placed on an equal footing with U.S. industry, thereby giving it both the opportunity and the incentive to do so.

Any regional free trade arrangement must make hard choices within six basic decision areas: (i) its geographic scope; (ii) the commodity coverage (i.e. the scope of commodities to be freely traded); (iii) the basic form of commercial policy arrangement (as between a free trade area and a customs union); (iv) the extent to which free trade is to be supplemented by steps toward "economic integration"; (v) the appropriate administrative organization; and (vi) the timing arrangements governing the entry into force of all

aspects of the free trade agreement.[31]

In their report on a possible plan for a Canada-U.S. free trade arrangement, the Canadian-American Committee discussed fully the basic principles of such a plan. In their view, the basic purpose quite simply should be to provide meaningful free trade so as to maximize its benefits to both participants. No attempt should be made at creating a closer economic union thus interfering with the internal or external commercial relations of the two partners. Most important of all as far as GATT and other world trading nations are concerned, the Canada-U.S. regional arrangement should aim at providing a basis for expanding rather than diverting international trade.[32]

However, any plan, hypothetical though it may be, cannot be built entirely on principles. Therefore, there are a number of underlying considerations which need be taken into account concerning Canada, the United States, their relationship to each other, and to other countries. Some of the more important considerations of such an agreement are as follows: the great difference in size between Canada and the U.S.; the bilateral rather than the multilateral nature of the agreement; Canada's fear of political absorption by the U.S.; adherence to the principles and ideals of GATT; industry resource needs and continental energy; commercial policy differences; and the federal nature of both countries.[33] Quite obviously, all the aforementioned could, apart from

merely shaping a free trade project, pose a vigorous challenge to its acceptability in any form.

5.3.8 Canadian Independence

By and large, Canadian dependence on the U.S. appears to have two facets: close trading relations; and large-scale participation of American capital in Canadian economic development. The question is: do these constitute a threat to Canadian independence and national identity? Furthermore what would be the implications of a further integration of the two economies through the formation of a North American free trade area? One thing for certain is that considerations of a broad political nature may be regarded as of much greater importance than any economic consequences.

As indicated in Chapter III, ideas of a basically similar nature (i.e. reciprocity) have been twice rejected in Canadian general elections, opposition to the proposals being framed mainly in terms of possible political consequences and the fear of annexation. Many Canadians feel that closer economic ties with the U.S. would weaken the east-west links among the widely dispersed regions of this country by encouraging a larger north-south trade thereby increasing Canada's reliance on the U.S. Moreover, those fearing annexation are often of the belief that Canada's unity and position of prosperity are based on the national

policy including substantial trade barriers. However, indications are that views on this score concerning the effectiveness of the national policy and the fear of political suicide are often much exaggerated. One need only point out that the tariff has often been a divisive rather than a cohesive force in matters of national unity and on occasion has been an important factor in provoking regional discontent.

Concerning trade, it is difficult to conceive of how a country can lose its independence by growing richer through the profitable international exchange of goods. On the contrary, wealth would give both North American countries an increasing capacity for individual self-fulfillment and the resources necessary for the achievement of national objectives. We only make ourselves poorer by insisting on producing at high cost within Canada things that can be obtained much cheaper on the international market.

With regard to the fear that Canada might drift into political union with the U.S., this would necessitate a significant shift in public opinion in Canada since most Canadians vigorously oppose such a move and current government policy is now aimed at maintaining Canadian independence. Even if a majority of Canadians wanted Canada to join the U.S., it is doubtful indeed that the U.S. would want us. The U.S. has arrived over time at a fairly delicate balance of political forces that no American politician would like to see disturbed,

apart from the unlikelihood that Congress would be amicable to admitting ten new states, none of which would likely be sympathetic to the American South. It seems far more plausible that rather than lead Canadians to desire political union with the U.S., as a result of economic integration, Canadian incomes would rise towards American levels and Canadians would have less incentive to join the U.S. politically and more freedom to pursue their own national objectives.[34] Canadians should recognize that "...growing interdependence is a fact of life in the modern world and...the essential elements of political sovereignty are not necessarily compromised by such interdependence."[35]

5.3.9 Conclusion

It is evident that each of the various types of economic integration proposed carries with it loss of political autonomy of varying degrees. But of all the schemes put forward, a North American Free Trade Area is seen to have the minimum political implications combined with a substantial economic gain. Whether or not U.S.-Canadian free trade would lead to some form of political unification or even to a more advanced form of economic integration such as a customs union would ultimately depend on whether or not the people in both countries believed it to be desirable.

Trade reliance does not inevitably lead to political

union; were this so, the national policy notwithstanding, the two countries would have long since become one. At the same time it must be recognized that closer economic integration would be bound to influence Canadian political views one way or the other. In Canadian politics, the widely-held idea that freer trade would eventually lead to political integration is evidence of the fact that the public's or the politicians view of reality may be of more consequence than reality itself.

To counter the fear of American domination, most Canadians would probably prefer a wider free trade arrangement to include the counter balancing effect of Great Britain and continental Europe. One is forced to conclude that Canadian political and economic considerations with regard to alternative free trade arrangements are in conflict. Based on a fear of long-run political consequences, Canadians would prefer the offsetting effect of multilateral tariff reductions by a broad grouping of nations such as AFTA. Of course, again in the long-run, the economic gains to be achieved would also be maximized under AFTA. However, the transition period to such a widespread multilateral free trade arrangement might best be accomplished from the Canadian point of view by a first step of North American integration. A Canada-U.S. regional free trade area would provide most of the potential free trade gains, while holding adjustment risks at a minimum.[36]

5.4 Economic Consequences

5.4.1 Introduction

If the Canadian government was successful in negotiating a general elimination of trade barriers between Canada and the U.S., Canadian industry would be provided with enormous new opportunities. However, because of the relative size of the two economies, almost the entire burden of industry reorganization would fall on Canada, and in particular on the secondary-manufacturing sector. A rationalized North American system implies U.S. specialization in roughly 90% of internationally traded goods, and Canadian specialization in only 10%. In order to survive, Canadian industry would have to move rapidly from high-cost production of full lines for domestic consumption to low-cost production of selected items for North American consumption.[37]

While it is difficult, if not impossible, to predict in any detail the economic consequences of such an arrangement, statistical analysis does provide some data on the direction and order of magnitude of the changes which would result. Canadian per capita gross national product is customarily 25 to 30% less than the American equivalent, allowances being made for price differences. This disparity can be resolved into its components thereby explaining some parts of it by differences in occupational distribution, labour force participation rates, and the net foreign investment position

of the two economies. These adjustments having been made, a residual difference of 15-20% remains. About half of this residual difference can be attributed to lower productivity in Canadian manufacturing, a difference which tends to be concentrated in industries which are producing more or less exclusively for the Canadian market. It is this gap which a free trade area would be designed primarily to close.[38]

Free trade with the U.S. is often dismissed in Canada on the grounds that, in such a situation, American industrial giants would merely increase their output by 10% and thereby eliminate manufacturing activities in Canada. Under analysis however, this contention is shown to lack validity. Indeed in the majority of industries with expanding markets, the Canadian location enhances its attractiveness significantly under free trade. If the issue confronting a firm is where to expand next, many firms, given the option of rationalizing Canadian operations or building anew in the States, would be likely to choose the former. It is not merely the vested interest in existing plant that would serve to help Canada retain and expand such activities. From the point of view of present or potential American and Canadian investors, Canada also enjoys a substantial cost advantage in the form of lower wages, an advantage which is generally only moderated, but not offset, by other cost differences.[39]

Persuasive arguments for a Canada-U.S. trade area may be summed up as follows: (i) despite barriers to trade along

the 49th parallel, underlying economic forces have been generating interdependence between the two countries, especially through trade. This result has been advantageous to both countries and has facilitated more rapid economic growth than would otherwise have been possible. Likewise there would be further advantages along these lines under free trade; (ii) despite some reduction in Canada-U.S. trade barriers the last 25 years, those remaining are still formidable and significantly limit productive efficiencies in various industries, especially in Canada. New forces intensifying competition in world markets and the trend toward regionalization of world trade are strongly accentuating the need to achieve the highest possible industrial efficiency.

5.4.2 Analysis

In attempting to analyse Canada's prospects under free trade with the U.S., a "two country" model of some sort might be expected to give a reasonable first approximation. Unfortunately the restructuring of industry following the introduction of free trade has received little attention in traditional international trade theory, and no techniques have been developed to handle this problem. The most extensive treatment in the literature has been done recently by P. and R. J. Wonnacott in their study of Free Trade Between the United States and Canada.[40] Consequently, their

findings will be depended on rather heavily as a basis for the succeeding discussion.

While an examination of Canadian costs in manufacturing might be expected to provide interesting background information, current cost figures are seriously inadequate as an indication of what Canada might produce efficiently under free trade and would provide a very doubtful basis for projecting free trade export capability. The simple fact is that present Canadian manufacturing costs and supply figures will become irrelevant under free trade. While manufacturing costs in Canada are generally higher than in the U.S., at least part of this difference can be traced to protection. As a consequence, present costs and techniques in Canada are irrelevant in free trade circumstances which would necessitate a complete reorganization of Canadian production to cut costs and increase specialization. Canadian costs would be forced down by increased competition from across the border and the scaling up by Canadian industry to service larger markets plus the lower costs of some industrial materials would significantly reduce the costs to certain Canadian manufacturing sectors.

To determine the extent to which past export performance can be used as a basis for projecting export capability under free trade, an examination of the Canadian tariff is useful. In sectors where the tariff is high, Canadian industry is unlikely to be able to match foreign

competition without a reorganization sufficient to transform its entire cost structure. Wilkinson lists three reasons why primary manufactures would be much less affected than secondary manufactures: (i) U.S. and Canadian tariffs are either quite low or non-existent relative to the tariffs on most secondary manufactures; (ii) Canada already exports much of her total output from the primary manufacturing sector, a reflection of the favourable tariff treatment already afforded such products; (iii) world demand for primary manufactures, which are essentially industrial materials, will likely continue to expand, in line with world industrial production.[41] Therefore, since the existing tariffs on industrial materials are low and these industries have already engaged in international competition, it is possible to estimate their export capabilities from our existing trade and tariff patterns.

Unfortunately, it is more difficult to project Canadian performance for manufactured goods. Estimating changes in exports from tariff reductions and present supply and demand conditions is inappropriate since Canadian supply responses would be transfored radically by the removal of tariffs. Therefore it is necessary to consider industrial costs not as they now exist but as they would exist under free trade. The analysis of trade in secondary manufactures then will be based on U.S.-Canadian cost differences and will concern the effect on the North American economy of reci-

procal U.S.-Canadian free trade, and the resultant third-country effects.

5.4.3 Trade in Primary Manufactures

In analysing the projected change in Canadian imports and exports of primary manufactures, it is necessary to distinguish two separate types: raw materials, and partially manufactured goods. Most raw materials are imported into Canada duty-free and even the protected items have a low tariff with the result that duty collected on Canadian imports of all raw materials equals less than 1% of their value. Consequently, freer trade will not subject raw materials to suddenly increased foreign competition. Changing trade patterns in partially manufactured goods are also computed in this way even though the assumption that present Canadian costs and supply responses would remain the same is less satisfactory since Canadian protection of semi-manufactures is considerably higher than protection of raw materials. Thus the Wonnacotts' tentative estimates indicate only what might occur, to the degree the rationalization of these Canadian activities proves unnecessary.

Exports--Since only 27% of Canada's exports of primary manufacturees incur a duty abroad, it is only this group of exports that would change as tariffs in receiving countries were eliminated. For raw materials, about 40% are dutiable and only the United States (by far the largest importer)

TABLE 5.9

PROJECTED INCREASES IN CANADIAN EXPORTS OF INDUSTRIAL MATERIALS IN AN ATLANTIC FREE TRADE AREA

(in millions of Canadian dollars, base year 1958)

	Assumption sets	United States	United Kingdom	Other industrial countries	Total
Raw materials	(1)	2.6	-	-	2.6
	(2)	11.8	-	-	11.8
Partially	(1)	29.5	- .6	.7	29.6
manufactured goods	(2)	119.1	-1.4	2.8	120.5
Total	(1)	32.1	- .6	.7	32.2
	(2)	130.9	-1.4	2.8	132.3

Source: Wonnacott, R.J., *op. cit.*, p. 58.

levies duties of any significance on Canadian goods of this kind. The estimated changes in Canadian exports that would result from the establishment of an Atlantic Free Trade Area (AFTA) were computed by the Wonnacotts' on a detailed product basis, using assumed elasticities and trade flows. These estimates were then aggregated and are presented in Table 5.9.

The two most notable results are: (i) the only substantial increase in raw materials exports would be to the U.S. since this is the only country that now levies significant duties on Canadian exports of resources; (ii) Canadian exports of partially manufactured goods to the U.K. would be reduced since there are many items subject to tariffs in the U.K. market which are admitted duty-free from Canada due to Commonwealth preference and if British tariffs against other AFTA countries were removed, AFTA's increased exports would displace both U.K. domestic supplies and Canadian exports.

Imports--Since no consideration need be given to the level of foreign tariffs, Canadian imports are easier to treat than exports. Canadian resource protection, when considering average tariffs on all items, dutiable and non-dutiable, appears to be less than resource protection in the countries to which Canada exports mainly because tariffs are levied here on fewer items. However, in the semi-processed category, Canadian protection is substantially greater than the pro-

tection other countries impose on Canadian exports.[47] A well-known difficulty in interpreting tariff averages of this kind is that the higher the tariff, the more it will restrict trade flows and the less its weight will be in the averaging process.

The combined estimate of changes in trade flows as a result of AFTA is given in Table 5.10.

Changes in import flows are seen to occur chiefly in items which there are now substantial imports despite Canadian protection. As for the combined effect on the balance of payments in Canada, the conclusion would appear to be clear. Regardless of assumptions made about the supply and demand elasticities, the elimination of tariffs would improve the Canadian balance of trade in these items, with increases in exports exceeding those in imports. This is true for both raw materials and partially manufactured goods. The largest possible net improvement is estimated at about $130 million, the smallest at about $15 million. This improvement would suggest a possible improvement in the Canadian current account in the range of $50-$100 million, the equivalent of 1% of the total 1958 current account of about $7 billion, and a 5 to 10% decrease in the current account deficit of over $1 billion in that year. The two reasons for this clear result: (i) Canada is already a large exporter in the primary manufactures sector, but not a large importer; (ii) the proportion of Canadian exports that is dutiable (25%)

TABLE 5.10

ESTIMATED CHANGES IN CANADIAN EXPORTS AND IMPORTS OF INDUSTRIAL MATERIALS COMBINED

(in millions of Canadian dollars, 1958 Base)

	Assumption sets	Imports	Exports	Trade balance
Raw materials	(1)	.9	2.6	1.7
	(2)	3.3	11.8	8.5
Partially manufactured goods	(1)	3.5	29.6	26.1
	(2)	14.1	120.5	106.4
Both categories	(1)	4.4	32.2	27.8
	(2)	17.4	132.3	114.9

Source: Ibid., p. 59.

is considerably less than the proportion (15%) of Canadian imports that is dutiable.[43]

5.4.4 Trade in Secondary Manufactures

As previously mentioned, the treatment of secondary manufactures is rendered more difficult than primary manufactures because of the extensive change expected in industrial costs under a free trade arrangement. However an analysis of costs plus the recent determinants of trade patterns should provide interesting background to any predictions of resulting Canadian trade in this sector.

Past Canadian performance seems to have been severely limited by high manufacturing costs. When comparing Canadian costs to those in the U.S., differences prevail on account mainly of the following four reasons: (i) restricted from free access to U.S. markets by the U.S. tariff and protected in their own domestic market by the Canadian tariff, Canadian manufacturers find themselves limited to a relatively small domestic market thereby forcing them to employ limited production runs, foregoing the large-scale economies of U.S. industry producing for a market 10 to 15 times as large; (ii) intermediate products are often more expensive in Canada because of tariff protection and lack of economies of scale; (iii) inherent reasons such as heavier transport costs, regional disparity, and higher capital costs, add to the cost gap; (iv) on the other hand, labour costs are lower in Canada

than in the U.S.

Current cost conditions would not hold under free trade; specifically cost differences (i) and (ii), traceable to the existence of the tariff, would tend to be eliminated under free trade . The ability of Canadian industry to compete would rest primarily upon the remaining inherent cost differences (iii) on changes in wage differentials (iv), and on the speed and ease of reorganization of industries to eliminate differences (i) and (ii). The key question is: would higher Canadian inherent costs be offset, or more than offset, by the Canadian wage advantage?

Wilkinson summarizes this approximation as follows:

> "If Canadian wage rates remained about 25% below U.S. rates...then, provided that the same economies of scale in production (both internal and external) were achieved in Canada as in the U.S., and managements were equally efficient in both nations, there would be a production cost advantage of perhaps 6 to 6 1/2% to locating plants in Canada rather than south of the border."[44]

Table 5.11 shows that in 1958, average American wages in manufacturing were greater than those in Canada by one third in terms of their respective national currencies.

Of course the Canadian labour cost advantage varies widely, depending on the wage differences and labour intensity of specific industries. It must be emphasized that these estimates depend on the assumption that labour productivity become equal in the two countries in free trade conditions. Since comparative studies show little difference in the efficiency of labour in Canada and the U.S.[45] it would

TABLE 5.11

FACTOR COSTS IN CANADA AND THE UNITED STATES, 1958

Industry	Capital costs: Effects on total costs of higher capital costs in Canada as compared to United States	Average hourly wage (production workers): Canada	Average hourly wage (production workers): U.S.
	per cent	(Canadian dollars)	(U.S. dollars)
Textiles and knitting mills	1.26	1.29	1.54
Apparel and related products	.35	1.09	1.51
Lumber and wood products	.79	1.46	1.74
Pulp and paper products	1.07	1.94	2.18
Printing and publishing	.48	1.93	2.60
Electrical machinery and apparatus	1.07	1.73	2.21
Chemical products	1.58	1.80	2.47
Petroleum and coal products	4.11	2.29	2.98
Rubber and plastics products	1.11	1.69	2.27
Leather and leather products	.76	1.15	1.60
Nonmetallic mineral products	1.27	1.77	2.19
Metallic products and nonelectrical machinery	1.38	1.91	2.55
Transportation equipment	1.00	1.91	2.66
Miscellaneous manufacturers	.73	1.65	2.17
Average, all manufacturing	1.15	1.65	2.19

Source: Ibid., p. 65.

appear that the fact that the average labour productivity in Canada is now lower than in the U.S. is due in whole or in part to the limited scale of Canadian production resulting from U.S. and Canadian trade barriers. Hence with similar capital equipment and production runs, labour productivity in comparable activities will tend to be the same in the two countries. It should not be assumed however, that the present wage advantage will continue indefinitely. To the degree that Canadian industry is successfully rationalized, Canadian wages and/or the value of the Canadian dollar would adjust to the new free trade situation.

Considering the net cost differences mentioned above, the Wonnacotts compared the most heavily industrialized areas in Canada and the United States (i.e. Ontario and Quebec and the Chicago-Boston-Washington triangle) for potential effects on trade between the two. It was found that in nine of thirteen industries examined there would be a total cost advantage in Canada of up to 10%, two having a cost advantage of up to 10% in the U.S., and for the remaining two, neither country having an advantage. (Table 5.12 final column) In addition to this any discount on the Canadian dollar would provide one more advantage to Canadian locations.

This net cost difference, depending on the import content of production; would imply an expansion of manufacturing in Canada, and higher levels of employment and exports. However the resulting pressure on the Canadian labour force and

TABLE 5.12

EFFECTS OF TRADE LIBERALIZATION ON THE CANADIAN EXPORT/ IMPORT BALANCE IN MANUFACTURED GOODS WITH INDUSTRIAL COUNTRIES OTHER THAN U.S.

	Stage 1	Stage 2		Stage 3
Industry	Effects of moving onto a competitive footing similar to U.S.	Further effects of freeing trade with other countries	Combined (1) and (2)	Canadian cost advantage (+) or disadvantage (-) vis-a-vis the U.S.
Textile, apparel and related products	+	-	+	+
Wood Products	+	-	+	+
Pulp and paper products	-	-	-	.
Printing and publishing	+	+	+	+
Electrical machinery	+	-	+	+
Chemical products	+	+	+	.
Petroleum and coal products	+	+	+	-
Rubber and plastics	+	+	+	+
Leather products	+	-	-	+
Nonmetallic mineral products	+	-	+	-
Metal products and non-electrical machinery	+	+	+	+
Transport equipment	+	+	+	+
Miscellaneous	+	-	+	+

Source: Ibid., p. 73.

the balance of payments would more than likely force up the level of the Canadian dollar and/or the relative Canadian wage level. This upward shift would thereby eliminate the absolute advantage (in terms of lower costs) in many Canadian industries, leaving lower costs only in industries of comparative advantage.[46] And it should be emphasized once again that the above results depend heavily on the assumption that rationalization and cost reductions will in fact take place in Canadian industry in response to the liberalization of trade.[47]

It follows that the removal of tariffs on trade between Canada and the U.S. would be economically beneficial to both and especially to Canada. The Canadian standard of living would no longer be depressed by the heavy burden of the tariff and removal of barriers to Canadian exports of manufactures to the U.S. would create the opportunity for the development of an efficient and progressive manufacturing sector in Canada. Processing of Canadian materials into finished products would tend to be carried on in Canada rather than the U.S. as is now compelled by the American tariff. Canadian manufacturers with free access to the large American market would be able to specialize and obtain the advantage of large-scale mass production, and to exploit the advantages of a lower wage level and location close to some of the richest market areas in the U.S. Competition in an integrated continental market would force them to be

efficient and progressive in order to survive.

It is customary for those who support the tariff to argue that the removal of tariff protection would virtually wipe out the whole of the Canadian secondary manufacturing sector. As Johnson states: "If this argument is correct, it would be a shocking testimony to the waste of Canadian economic potential that the tariff has produced, and a damning indictment of the incompetence of the Canadian businessman."[48] Replacement of protection by free trade would lead to some radical changes in the structure of Canadian industry, but there are various reasons for expecting that it would not drastically alter the balance of the Canadian economy as between manufacturing and other activities, or even the relative importance of various industries.

A number of Canadian industries have either demonstrated their ability to compete with American firms in equal competition or claim that they could do so. One of the perennial arguments advanced by Canadian industries seeking protection is that the small size of the Canadian market makes them unable to compete with American firms at American prices. While this is not a valid argument for protection, if the facts are as claimed, access to the American market on equal terms should permit such industries to thrive.

Arguments raised in connection with the Common Market and the Free Trade Area in Europe, and some studies of the probable effects of European integration on the industries

of the participating countries, are highly relevant to the Canada-U.S. case. These showed that differences in comparative advantages and relative production costs were not generally differences applying to whole industries or firms, but rather differences applying to particular products.[49] The conclusion was that the adjustment to free trade would take the form of change in the commodity pattern of production of industries in various countries, rather than in the industrial pattern of their economies. This conclusion probably would apply also to a Canada-United States free trade area; consideration of the wide variations in the relative prices of the products of the same industry in Canada and the United States, listed in the Appendix to Young's study of Canadian Commercial Policy,[50] tends to confirm this.[51]

It would appear therefore that in the absence of American and Canadian tariffs, the performance of the Canadian secondary manufacturing industry would be improved significantly as a result both of changes in productive techniques within industries and shifts among industries. Other sectors of the economy such as retail and wholesale trade, transportation, and services would also be affected, but it is more difficult to trace through and predict the effects that the reduction of trade barriers would have on their development.

5.4.5 <u>Third Country Effects</u>

Whereas the major effects of free trade on Canada would come from changes within North America, such a move would also have substantial effects on Canada's trade with third countries. Given the expected transformation of the Canadian economy, there is no easy method for analyzing Canada's changing trade patters with third countries in specific quantitative terms. However, it is possible to take account of the major influences that would determine changing trade patterns and outline the broad dimensions of change.

Once again the assumption is made that factor costs will be similar in the U.S. and Canada, following complete rationalization under free trade. Canadian industry, operating at U.S. cost levels should be in a position to more closely match U.S. export performance in third countries, and would be roughly as vulnerable to imports from these countries. By moving, in terms of both domestic costs and tariff treatment, from the present Canadian position to the present American position, any change in the Canadian trade balance in manufactured goods would be towards the present American position. For estimating purposes, Wonnacott used the simpler assumption of a customs union, with tariffs in both countries at present U.S. rates, in comparing the Canadian export-import balance with the American. The direction of this change is shown for each industrial sector in the first column of Table 5.12.

To the extent that Canadian costs are reduced with the rationalization of North American industry, and both import-competing and export industries in Canada more closely match U.S. performance, the Canadian import-export balance would tend to improve, as is reflected in the number of positive signs of column (1).

Should tariffs between North America and third countries be eliminated following free trade between Canada and the U.S., the direction of the change for each Canadian industry is estimated in the Table 5.12 column (2). Here, the pattern appears to be quite mixed with imports expanding more rapidly than exports in some cases, and in others, the opposite effect is true. Wonnacott then took the roughly comparable numerical estimates of columns (1) and (2) and derived an estimate of the net effect for each industry to be shown in column (3). The results imply that, under the assumptions made previously, the major potential change in Canadian export performance with third countries would come, not as a result of tariff reductions with third countries, but as a result of the improved competitive position of Canadian industry following North American trade liberalization.

The computations leading to the observations shown in columns (1) and (2) were based on the assumption that total costs (including factor costs and transport costs) would be the same under free trade for producers in both Canada and the U.S. However, under the different assumption that

labour productivity in Canada reached the U.S. level while present wage differences were maintained, Canadian producers would have a cost advantage in many industries, with lower wage costs more than compensating for higher transport and capital costs. The cost advantage (+) or disadvantage (-) was calculated by Wonnacott and is shown in the last column of Table 5.12.

The two groups of Canadian industrial sectors as distinguished in the Table are: (i) the two indices differ in sign giving no clear indication of likely expansion or contraction of the industry; (ii) both indices point to Canadian expansion (i.e. 8 of the 13 sectors). This net effect would seem to indicate an improvement in Canadian export performance in manufactured goods under the assumption of unchanged wage rates and exchange rates.

The ability of Canadian industry to compete in third countries vis-a-vis the U.S. is further enhanced by the present discount on the Canadian dollar. But as indicated earlier, wages and/or the exchange rate will appreciate in Canada in the process of adjustment. Correspondingly, the results of Table 5.12 do not show the pattern of specialization in Canadian industry but provide an indication of the competitive position of the rationalized Canadian industry under the stated assumptions. Experience of the Common Market indicates however the predominance of intra-industry specialization as opposed to inter-industry specialization.

Thus Canadian specialization is most likely to occur within industrial categories, rather than between them.[52] Wilkinson indicates that:

> "A more refined version of this argument is that rather than specialization by industry, there would be intra-industry specialization, with Canada gaining the labour-intensive processes."[53]

Wilkinson also concludes that the alterations in secondary manufacturing as a result of free trade may not be nearly as great as is often claimed and that the resulting pattern of industrial production, exports, and imports, may not be that much different than what it is at present. Nevertheless, where large marketing organizations have to be developed to serve either abroad or in the U.S., the Canadian firm may find itself at a decided disadvantage vis-a-vis U.S. firms. As a result, Canadian firms may be likely to thrive best under free trade conditions in the short-run in those industries where the costs of selling abroad are relatively small.[54] Government aid in the form of export promotion, investment and export financing, would no doubt be of assistance throughout the period of rationalization.

Another facet of third country effects of North American economic integration concerns Canada's traditional granting of preferences to Commonwealth countries. If North American integration were to take the form of a free trade area, Commonwealth preferences (in particular, those between the U.K. and Canada) might be retained in whole or in part for unless concessions granted to the U.S. were generalized

to Commonwealth countries, Canada would be in the position of extending more favourable treatment to imports from the U.S. Of course with the U.K. now negotiating to enter the EEC, Commonwealth Preferences may soon be a thing of the past.

Commenting on this possibility, Johnson predicts that:

> "Canada's reaction would probably be to terminate Commonwealth preferences--a reaction which, if widespread around the Commonwealth, would amount to a substantial retrogression into protectionism."[55]

The retaining of Commonwealth preferences by Canada following North American free trade would not be consistent with GATT however. Under the GATT arrangements, Canada would be placed in the position of theoretically extending concessions either to all GATT countries outside the NAFTA or to none.

5.5 Conclusion

This last chapter has served as a logical extension of the argument presented in the earlier sections of this study. The change in competitive conditions in Canada resulting from reciprocity with the U.S. might have a significant effect on all sectors of the economy, although the greatest change would occur in secondary manufacturing. A substantial increase in productivity in this important sector would have the effect of narrowing the income differential between Canada and the United States, although even under conditions

of continental free trade, some disparity in average per capita income would probably remain.

Following tariff elimination, the greater degree of competition would cause Canadian industry to rationalize causing a shift of labour and capital from the less to the more efficient activities, a shift which would be reflected in a rise in Canadian real income. In the initial period, free trade benefits might be partially offset by adjustment costs. It is therefore only as regards the long-run effects that the conclusion is clear: the net effects of free trade may be conservatively estimated at 10% of Canadian income and this rise in income would be above and beyond the normal rise in income that might be expected over time.[56] Hence the U.S.-Canadian income gap would be narrowed, and with more equal job opportunities in Canada, the historic "brain-drain" would presumably be reduced, if indeed this is not already the case.

Johnson succinctly sums up the situation when he states:

> "...a growing body of responsible Canadians in both business and academic life, has been questioning the conventional wisdom of Canadian tariff policy, and coming to the conclusion that economic integration with the U.S. offers a golden opportunity for Canada to fulfill its national aspirations for affluence and independence."[57]

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CHAPTER VI

SUMMARY AND CONCLUSIONS

Economic analysis, it must be recognized, can only make a limited contribution to decisions on policy matters. This would be the case even if a full and accurate description could be given of all the economic consequences of alternative policies. This rarely can be done. Thus when the policies being considered are highly controversial, there is a tendency, to the extent that there is uncertainty in the analysis, for personal bias to creep into the interpretation of facts. In full recognition of these hazards, an attempt has been made to test several hypotheses with regard to the effects of protectionism in Canada and the effects of the lowering of trade barriers in the general direction of multilateral free trade.

The first hypothesis stated: "the national policy in Canada, rather than permitting Canadians to remain independent from the United States while encouraging rapid economic growth and diversification, has instead had almost the opposite effect resulting in both the development of a branch-plant economy in Canada with a dependence on American capital and a sizeable reduction in the Canadian standard of living". In testing the first hypothesis, the adequacy has been questioned of conventional interpretations of one of Canada's most ahllowed national policies, protectionism, by reference to the economic

history of Canada and to some speculation about the contemporary Canadian economy. Several studies on the long-run costs of protectionism have been examined including J.H. Young's Canadian Commercial Policy which dealt with Canadian economic prospects.[1] As pointed out in Chapter III, these have indicated the probable economic cost of the National Policy to Canada in terms of a general weakening of economic efficiency to be heavy indeed, of an order of magnitude perhaps much in excess of the "cost of the tariff" as conventionally calculated.

While protection is said to be a means of increasing the standard of living and promoting economic growth, it was indicated in Chapter IV, dealing primarily with the costs of the tariff, that in an advanced economy like Canada's the reverse is true. It was found in fact that protection promotes: (1) inefficient allocation of resources; (2) in place of industrial specialization and the economics of large-scale production, it fosters fragmentation of the market, inefficiently small production units, excessive diversification of products, and short production runs; (3) by fostering inefficiency, protection reduces the standard of living; and (4) in the long-run, an established policy of protection promotes resistance to economic change, often taking the form of demanding increased protection to avoid the need of adapting to change.

Not only did the National Policy serve to reduce somewhat the Canadian standard of living but it also had the following dysfunctions: (1) protection was intended to foster

and promote Canadian industry, Dales has indicated that the National Policy was instrumental in the formation of an American branch-plant economy in Canada;[2] (2) and while the tariff was meant to promote national unity through east-west trade, it has been one of the main causes of regional conflict in Canada resulting from the fact that the consumers in the Maritimes and Western Canada pay higher prices to subsidize central Canadian industry as pointed out by the Economic Council of Canada.[3]

The conventional argument on the topic of free trade versus the tariff is as follows: the tariff protects Canadian industry; it thereby allows inefficient high-cost production behind its walls; this raises prices to the Canadian consumer and lowers his real standard of living; the tariff therefore takes the form of a private tax levied in support of the protected sectors of the economy. As Young made clear, the order of magnitude is very probably well in excess of $1 billion a year.[4] Many of the arguments for tariff protection were dealt with in Chapters II and III, and while some arguments may appear to be valid, this study indicated that their relevance to the technologically advanced Canadian economy seems slight.

With regard to the first hypothesis the principle results of this analysis can be summarized in one sentence:

> "In general and over the long-run, increases in protection can be expected to lead to economic losses, and decreases in protection to economic gains... for the vast majority of Canadians".[5]

This follows not only from the direct effect of the Canadian tariff on the Canadian economy, but also from the effect Canadian commercial policy has on the treatment accorded this country's exports. However, it must be emphasized the Canadian tariff policy is political as well as an economic instrument. It is therefore quite possible for those who are in agreement on the economic implications of a given policy to hold different views on the best policy to be pursued at any particular time.

After testing the second hypothesis that "much would be gained in Canada from a policy of multilateral trade reduction beginning with closer economic integration and the lowering of trade barriers between Canada and the United States", it appears indeed that Canada's economic interests lie in the new movement towards nondiscriminatory multilateral free trade. Canada should therefore declare her willingness to reduce or eliminate tariffs while pressing for a more immediate regional integration on a North American scale.

As Johnson makes clear, the spread of industrialization around the world, the trend towards regionalization of trade and the requirements of sustained economic progress in a changing world economy point out the need for flexibility in changing from activities in which comparative advantage is disappearing to activities in which new comparative advantage is appearing.[6] The analysis in Chapters IV and V showed that the more liberal the trading policies pursued by other nations,

the greater the opportunity for Canada to exploit its comparative advantages by developing to the full the advantages of large-scale production and technological leadership in specialized branches of economic activity. More important, it was found that the lower the level of Canadian tariffs, the greater the incentive to Canadian producers to determine where Canadian comparative advantage lies and to exploit it to the fullest possible extent.

The Wonnacotts' study of Free Trade Between the United States and Canada[7] is quoted extensively in Chapter V as evidence of the fact that Canada's economic interests lie in the direction of lower trade barriers as stated in the second hypothesis. Economic integration with the U.S. in particular offers Canadian manufacturers the opportunity to escape the inefficiencies inherent in producing for a relatively small protected market and to reap instead the economies of large-scale long-run production of the high degree of industrial specialization of the U.S. Given the lower wage level in Canada, the proximity of the Canadian industrial heartland to major American markets, and the fact that the U.S. tariff now imposes substantial barriers to imports of Canadian manufactures, the most likely result of such a move would be both a substantial increase in Canadian manufacturing and a substantial rise in Canadian incomes and living standards. On evidence from a study of the EEC, when industry is given time to make the adjustment to the new comparative situation,

freer trade leads to international specialization by products within industries rather than to the specialization by different countries in different industries.[8]

Canada should therefore abandon her traditional policy of promoting industrialization by tariff protection in favour of a liberal trading policy better designed to foster Canadian growth in a changing world economy. Acceptance of this recommendation would require a fundamental rethinking of accepted ideas on Canada's place in the world of international trade. The 20th century, instead of belonging to Canada, belongs to all nations of the world according to their capacity to make the best of the resources they have. In that endeavour, Canada has a fortunate head start over most nations in technology, capital, human skill, and natural resources; and she has every change of continued prosperity and growth provided she has the courage required to seek wider horizons in managing her own economic affairs in the new international economy.

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